Supreme Court, U.S.
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No.

In the
SUPREME COURT OF THE UNITED STATES

RONALD J. SOMMERS, TRUSTEE,
Petitioner,

v.

WELLS FARGO BANK OF TEXAS, N.A.,
Respondent.

On Petition For A Writ of Certiorari to the
United States Court of Appeals for the Fifth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

I. If a bankruptcy court modifies the automatic stay in effect under 11 U.S.C. § 362 and allows a creditor to pursue state law claims against a third party, are bankruptcy law remedies affecting that third party barred?

II. If a bankruptcy trustee agrees not to oppose a creditor's request to modify the automatic stay and pursue state law claims against a third party, is the bankruptcy trustee estopped from asserting bankruptcy law remedies against that third party?

PARTIES TO THE PROCEEDINGS BELOW

Appellant:

Wells Fargo Bank of Texas, N.A.

Appellee:

Ronald J. Sommers, Trustee

TABLE OF CONTENTS

Page

OPINIONS AND JUDGMENTS BELOW 1

JURISDICTION 1

STATUTES INVOLVED 2

STATEMENT OF THE CASE 4

A. Summary of the Case 4

B. Wells Fargo Loaned Money to Peerbhai Relying On the Credit of AIA 5

C. When the Companies Filed Bankruptcy, Wells Fargo Pursued Peerbhai. 6

D. The Bankruptcy Court Concluded That Substantive Consolidation Was Proper. 7

E. The Court of Appeals Concluded That Modifying the Stay Worked an Estoppel. 9

REASONS FOR GRANTING THE PETITION 11

A. A Conflict Exists Among the Circuits on Whether an Order to Modify the Automatic Stay Has Preclusive Effect. 11

1. In the First, Seventh, Ninth, and Eleventh Circuits, an order modifying automatic stay is a summary proceeding with no preclusive effect. 11

2. The Fourth and Fifth Circuit Courts give preclusive effect to an order modifying the stay. 14

B. Giving Preclusive Effect to an Order Modifying the Automatic Stay Contradicts Bankruptcy Statutes and Policy. 16

1. That an order modifying the stay has preclusive effect is not warranted by the statutory language. 16

2. Congress's intent was to keep the proceeding to lift the automatic stay a summary proceeding. 18

3. Assigning preclusive effect to orders modifying the automatic stay is bad bankruptcy policy. 20

4. Wells Fargo knew that it was taking liens on Peerbhai's real estate paid for with AIA's assets. 22

CONCLUSION 25

TABLE OF AUTHORITIES

Cases

County Fuel Co. v. Equitable Bank Corp.,
832 F.2d 290 (4th Cir. 1987) 15, 16

Grella v. Salem Five Cent Savings Bank,
42 F.3d 26 (1st Cir. 1994)..... 12, 13, 17, 18

Jefferson v. Mississippi Gulf Coast YMCA, Inc.,
73 B.R. 179 (S.D. Miss. 1986) 15

Jim Walter Homes, Inc. v. Saylors,
869 F.2d 1434 (11th Cir. 1989) 13

In re Taylor,
884 F.2d 478 (9th Cir. 1989) 14

Vitreous Steel Products Co. v. Miller,
911 F.2d 1223 (7th Cir. 1990) 11, 12, 18

Wells Fargo Bank of Texas, N.A. v. Sommers, Trustee, 444 F.3d 690 (5th Cir. 2006)..... 10, 14, 15

Statutes and Legislative History

11 U.S.C. § 362 ii

11 U.S.C. § 362(d) 2, 16, 17

11 U.S.C. §§ 547, 548 21

28 U.S.C. § 1254(1) 1

28 U.S.C. §§ 157, 1334 4

Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 2005 U.S.C.C.A.N. (119 Stat.) 23 17

H.R. Rep. No. 95-595 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963 ..... 19, 20

S. Rep. No. 95-989 (1978) *reprinted in* 1978 U.S.C.C.A.N. 5787 ..... 18, 19

OPINIONS AND JUDGMENTS BELOW

A separate appendix to this petition contains the opinions that the courts below issued. The opinions are as follows:

In re Amco Insurance Agencies, Inc., No. 02-31265-H5-7 (Bankr. S.D. Tex. Sept. 25, 2003) (findings of fact)

In re Amco Insurance Agencies, Inc., No. 02-31265-H5-7 (Bankr. S.D. Tex. Nov. 19, 2003) (order)

Wells Fargo Bank of Texas, N.A. v. Sommers, Trustee, No. 4:04-CV-455 (S.D. Tex. Sept. 6, 2004) (order)

Wells Fargo Bank of Texas, N.A. v. Sommers, Trustee, No. 4:04-CV-455 (S.D. Tex. Sept. 6, 2004) (judgment)

Wells Fargo Bank of Texas, N.A. v. Sommers, Trustee, 444 F.3d 690 (5th Cir. 2006)

JURISDICTION

The court of appeals entered its judgment on March 31, 2006. Sommers filed a petition for rehearing on April 14, 2006. The Fifth Circuit Court of Appeals denied the petition for rehearing on May 4, 2006. This Court's jurisdiction to review the court of appeals' judgment arises from 28 U.S.C. § 1254(1).

STATUTES INVOLVED

11 U.S.C.A. § 362(d) (West 2004 & Supp. 2006)

On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest;

(2) with respect to a stay of an act against property under subsection (a) of this section, if--

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization;

(3) with respect to a stay of an act against single asset real estate under subsection (a), by a creditor whose claim is secured by an interest in such real estate, unless, not later than the date that is 90 days after the entry of the order for relief (or such later date as the court may determine for cause by order entered within that 90-day period) or 30 days after the court determines that the debtor is subject to this paragraph, whichever is later—

(A) the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or

(B) the debtor has commenced monthly payments that—

(i) may, in the debtor's sole discretion, notwithstanding section 363(c)(2), be made from rents or other income generated before, on, or after the date of the

commencement of the case by or from the property to each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien); and

(ii) are in an amount equal to interest at the then applicable nondefault contract rate of interest on the value of the creditor's interest in the real estate; or

(4) with respect to a stay of an act against real property under subsection (a), by a creditor whose claim is secured by an interest in such real property, if the court finds that the filing of the petition was part of a scheme to delay, hinder, and defraud creditors that involved either—

(A) transfer of all or part ownership of, or other interest in, such real property without the consent of the secured creditor or court approval; or

(B) multiple bankruptcy filings affecting such real property.

If recorded in compliance with applicable State laws governing notices of interests or liens in real property, an order entered under paragraph (4) shall be binding in any other case under this title purporting to affect such real property filed not later than 2 years after the date of the entry of such order by the court, except that a debtor in a subsequent case under this title may move for relief from such order based upon changed circumstances or for good cause shown, after notice and a hearing. Any Federal, State, or local governmental unit that accepts notices of interests or liens in real property shall accept any certified copy of an order described in this subsection for indexing and recording.

STATEMENT OF THE CASE

A. Summary of the Case

This case arises from bankruptcy proceedings in which the district court (and the bankruptcy court, by referral) had subject matter jurisdiction pursuant to 28 U.S.C. §§ 157, 1334.

Petitioner Ronald J. Sommers was appointed as trustee of the bankruptcy estates of two companies—Amco Insurance Agencies, Inc. ("AIA") and Amco Insurance Group ("AIG"). In the AIG case, Sommers agreed not to oppose an order modifying the automatic stay and allowing creditor Wells Fargo Bank of Texas, N.A., to pursue a state court lawsuit against Rehmat Peerbhai, the primary shareholder of AIG and AIA. Wells Fargo settled its claims against Peerbhai and received, among other things, liens on Peerbhai's real estate. But when Sommers later learned that Peerbhai had paid for the real estate using funds that he had pilfered from AIA, the bankruptcy court granted Sommers' request for a substantive consolidation of Peerbhai's bankruptcy estate with AIA's bankruptcy estate. The consolidation nullified the liens that Wells Fargo had received in its settlement with Peerbhai.

The district court ruled that the substantive consolidation was proper. The court of appeals ruled that the substantive consolidation was improper on the grounds that the bankruptcy court, having modified the stay and allowed Wells Fargo to proceed with its claims, could not apply bankruptcy law remedies to nullify the results of Wells Fargo's efforts.

B. Wells Fargo Loaned Money to Peerbhai Relying On the Credit of AIA

Rehmat Peerbhai was the primary shareholder of AIA and the primary shareholder of AIG. In September 2000, Peerbhai approached Wells Fargo to obtain loans, and Wells Fargo extended two loans to Peerbhai and AIG (R. 280). One was a $2.4 million loan to both Peerbhai and AIG, secured by real estate. The other was a revolving line of credit to AIG in the amount of $1.2 million, but with Peerbhai as a guarantor. AIA was not an obligor on either loan, as a co-maker or guarantor. But in deciding whether to make these loans, Wells Fargo reviewed consolidated financial statements of Peerbhai, AIG, and AIA together. Calvin admitted that when Wells Fargo made these loans, it knew that AIA was the primary operating entity; that the source of the income reflected on the consolidated financial statements was AIA; that income from AIA was going to be the primary source for the repayment of the loans; and that apart from AIA, Peerbhai had a negative net worth (R. 366, 368, 370, 373, 377).

Thus, Wells Fargo knew that apart from the assets of AIA, neither Peerbhai nor AIG had sufficient assets with which to repay the loans. Wells Fargo also knew that AIG and AIA were separate corporations—not parent-subsidiary—and that Peerbhai owned both companies. And though AIA never signed a guarantee or note, Wells Fargo nevertheless anticipated that income from AIA operations would provide the primary source for repaying the loans (R. 376, 378).

Up until 1999, the majority of AIA's retail outlets were company stores, but that year Peerbhai began selling AIA company stores to friends, family, and other investors to be operated as franchises. For the most part, however, funds generated by the sale of the stores did not go to AIA; instead, Peerbhai personally collected the proceeds from these transactions. By the end of 2001 there were no more company stores at all – Peerbhai had by then converted the majority of AIA's assets into franchise locations (R. 268-69). Peerbhai also used the Wells Fargo loan proceeds to pay off personal obligations. In 2001, most of AIA's assets were sold to PC Group Acquisition II, Inc., for $1.5 million, with the proceeds paid directly to Peerbhai (R. 247, 349). Peerbhai used those sales proceeds to pay mortgages on real estate that he owned personally.

C. When the Companies Filed Bankruptcy, Wells Fargo Pursued Peerbhai.

In January 2002 Wells Fargo sued Peerbhai in state court, asserting breach of the loan documents. In February 2002, AIA and AIG filed for bankruptcy. Sommers was appointed a trustee in each case. Wells Fargo then asked the court in the AIG case to modify the automatic stay so Wells Fargo could pursue its lawsuit against Peerbhai. Sommers agreed not to oppose the request, and the court modified the stay to allow Wells Fargo to pursue the lawsuit. In April 2002, Wells Fargo and Peerbhai then signed a "Limited Forbearance Agreement" whereby Peerbhai paid Wells Fargo $100,000, agreed to a judgment of about $3.5 million, and gave Wells Fargo liens on his real estate. Wells Fargo knew that Peerbhai had paid the mortgages on the real estate by using funds he had

pilfered from the sale of AIA's assets (R. 214-16, 340-47; Trustee Ex. 144).

The stay was modified a mere six weeks after AIG had filed for bankruptcy. At the time, AIA's statement of financial affairs did not show the extent to which Peerbhai had been looting AIA, and Peerbhai continued concealing that fact. Only after the completion of the creditors' meeting, the examination of Mr. Peerbhai, and inspection of company financial records, did Sommers discover the extent to which Peerbhai had looted AIA. He then asked the bankruptcy court to order a substantive consolidation of Peerbhai and AIA's estates (R. 107-40, 553-61). Peerbhai filed for bankruptcy the day before the hearing on Sommers' application, and so AIA and Peerbhai were both in bankruptcy when the court finally held the hearing on the application.

D. The Bankruptcy Court Concluded That Substantive Consolidation Was Proper.

After a two-day evidentiary hearing on Sommers' application for substantive consolidation, the bankruptcy court made fact findings regarding Peerbhai and Wells Fargo's conduct, finding among other things:

- Peerbhai and AIA commingled assets, treated AIA's assets as Peerbhai's assets, and failed to keep records of the commingling; Peerbhai and AIA effectively operated as a single financial entity prior to the date of AIA's bankruptcy.

- Peerbhai used AIA's corporate status to commit fraud against its creditors.

- Peerbhai took at least $3 million—and probably more—from AIA in the two years before AIA's bankruptcy.

- In making the loans at issue, Wells Fargo did not rely on the separate credit of Peerbhai, AIA, or AIG.

- "Peerbhai treated AIA as an alter ego of himself, taking money out of AIA without observing corporate formalities, usurping corporate assets for his own benefit, and effectively consolidating his own financial being with that of AIA *in a way that could not have been ignored by Wells Fargo . . .*"

- "*In light of Wells Fargo's knowledge and the circumstances surrounding the execution of the Limited Forbearance Agreement,* Wells Fargo is not unfairly harmed by substantive consolidation . . ."

(R. 167-73) (emphasis added).

The court's order for substantive consolidation of the AIA and Peerbhai bankruptcy estates was made retroactive to February 2002, when AIA had filed for bankruptcy. By making the substantive consolidation retroactive to February 2002, the "Limited Forbearance Agreement" signed by Peerbhai in April 2002 was invalidated. In the absence of the substantive consolidation, Wells Fargo would be the beneficiary of nearly $1.5 million worth of AIA assets, which had

been sold and the proceeds applied to mortgages on the real estate that Peerbhai then pledged to Wells Fargo, even though AIA had never been obligated to repay either loan to Wells Fargo.

E. The Court of Appeals Concluded That Modifying the Stay Worked an Estoppel.

Wells Fargo appealed to the district court, which affirmed the bankruptcy court, and Wells Fargo then appealed to the U.S. Court of Appeals for the Fifth Circuit. Throughout the appeals, Wells Fargo never challenged the bankruptcy court's findings—including a finding that "[t]he trustee's agreement to an order lifting the stay in [AIG]'s bankruptcy case does not operate as any form of estoppel against substantive consolidation or against any avoidance actions that the trustee may file after consolidation" (R. 167).

Nevertheless, the court of appeals concluded that the bankruptcy court had improperly granted the substantive consolidation. The court concluded that, because the bankruptcy court had modified the automatic stay and allowed Wells Fargo to pursue the state court lawsuit, the court had acted improperly in "invalidating its authorization some twenty months later" by ordering the substantive consolidation *nunc pro tunc*. The court of appeals concluded that the substantive consolidation was a "reversal of course," an "untimely withdrawal" of the bankruptcy court's "earlier approval" that "contradict[ed] its previous order" and "worked to the significant prejudice of Wells Fargo." *Wells Fargo Bank of Texas, N.A. v. Ronald J. Sommers*, 444 F.3d 690, 695-96 & n.4 (5th Cir. 2006). The court of appeals reasoned as follows:

> The bankruptcy court, by granting the motion to lift the stay, and Sommers, by agreeing to it, explicitly authorized and consented to Wells Fargo's pursuit of state court remedies against Peerbhai. Because of this green light by the bankruptcy court, Wells Fargo expended its time and money to pursue the state court litigation until the suit concluded in the Limited Forbearance Agreement. Yet, when Sommers later filed his motion for substantive consolidation . . . he then sought to undo what he had earlier specifically authorized by applying the consolidation of the estates nunc pro tunc. In granting the motion, the bankruptcy court stated that "[t]he avoidance of the liens granted to Wells Fargo by Peerbhai pursuant to the Limited Forbearance Agreement would simply return Wells Fargo to its position as of the petition date." We think it was a little late for this reversal of course.

Id. at 695. The court of appeals vacated the district court judgment and remanded for further proceedings.

REASONS FOR GRANTING THE PETITION

A. A Conflict Exists Among the Circuits on Whether an Order to Modify the Automatic Stay Has Preclusive Effect.

The circuits are split on whether an order modifying the automatic stay serves to preclude remedies under bankruptcy law that affect the results or relief obtained in the proceedings for which the stay was modified.

1. *In the First, Seventh, Ninth, and Eleventh Circuits, an order to modify the automatic stay is a summary proceeding with no preclusive effect.*

In *Vitreous Steel Products Co. v. Miller*, 911 F.2d 1223 (7th Cir. 1990), the U.S. Court of Appeals for the Seventh Circuit considered the bankruptcy court's decision that claims in an adversary complaint were barred by the order modifying the automatic stay—and ruled that such claims were not barred. During the hearing on the creditor's motion to modify the stay, the trustee argued that the bank acted collusively with another investor to sell the debtor's business and that the bank and the investor ignored the actual value of the assets. *Id.* at 1229. The bankruptcy court modified the stay and specifically found that there had been no collusive effort and that the sale was commercially reasonable. *Id.* One week after the stay was modified, the bank completed its pending foreclosure. *Id.*

The trustee appealed the order modifying the stay and also filed an adversary complaint against the bank and investor, alleging, among other things, fraudulent transfer, fraudulent conveyance, and commercially unreasonable sale. *Id.* at 1230. The bank and investor moved for summary judgment on the complaint, and the bankruptcy court ruled that the above claims were barred, having been decided on the motion to modify the stay. *Id.* But the court of appeals said the claims had not been resolved by the order:

> Collateral estoppel is not a bar because the only issues necessarily decided at the § 362 hearing were whether the Bank had a colorable claim of a lien and whether the amount of that lien exceeded the value of the property. It was not necessary to reach questions of whether [the investor] had colluded with the Bank, or questions of preferential transfers . . . or . . . fraudulent conveyances . . . or commercial reasonableness . . .

Because those issues could not properly be raised at the hearing on the motion to lift the stay, the order lifting the stay was not *res judicata* on those issues." *Id.* at 1234.

In *Grella v. Salem Five Cent Savings Bank*, 42 F.3d 26 (1st Cir. 1994), the U.S. Court of Appeals for the First Circuit adopted the reasoning in *Vitreous Steel* in considering the argument that the "allowance of a motion for relief from stay does not preclude the later prosecution of a preference action" because the later action is not part of the court's decision to grant relief

from stay. The court agreed and ruled that a hearing on a motion to modify the stay was meant to be a summary proceeding and that the Bankruptcy Code required a court to act quickly in such a situation. *Id.* at 32. The court was influenced by what it perceived to be the limitations in the statute's language authorizing courts to modify the stay under certain circumstances. *Id.* This analysis has "led most courts to find that such hearings do not involve a full adjudication on the merits of claims, defenses, or counterclaims, but simply a determination as to whether a creditor has a colorable claim to property of the estate." *Id.*

In *Jim Walter Homes, Inc. v. Saylors*, 869 F.2d 1434 (11th Cir. 1989), the U.S. Court of Appeals for the Eleventh Circuit addressed whether a Chapter 13 plan may cure a home mortgage arrearage when the debtor has already received a Chapter 7 discharge of the underlying mortgage debt. The creditor argued the absence of good faith because the debtor filed the Chapter 13 petition on the day after the bankruptcy court had modified the automatic stay in the Chapter 7 case. *Id.* at 1438. The creditor reasoned that this filing negated good faith because "the lifting of the automatic stay in the chapter 7 case was a final adjudication of [the creditor's] right to foreclose and, under the doctrine of res judicata and collateral estoppel, [the debtor] can no longer question [the] adjudication." *Id.* The court of appeals disagreed and concluded that "in no way did the order [to modify the stay] purport to be a permanent adjudication" of the creditor's right to foreclose. *Id.*

In *In re Taylor*, 884 F.2d 478 (9th Cir. 1989), the U.S. Court of Appeals for the Ninth Circuit examined whether an order to modify the stay in a Chapter 13 case is "entitled to both claim preclusive and issue preclusive effect in subsequent Chapter 13 proceedings." *Id.* at 481. The court stated that the order modifying the stay "was not a 'valid judgment' for purposes of preclusion law." *Id.* at 482. The court affirmed the lower court's decision not to apply *res judicata* to the order. *Id.*

2. *The Fourth and Fifth Circuit Courts give preclusive effect to an order modifying the stay.*

As noted above, the court of appeals concluded in the present case that the substantive consolidation was improper because the bankruptcy court had previously modified the automatic stay and allowed Wells Fargo to pursue the state court lawsuit against Peerbhai. The court of appeals did not cite authority regarding preclusion or estoppel, but that was the court's reasoning. The court said that this was "reversal of course," an "untimely withdrawal" of the bankruptcy court's "earlier approval" that "contradict[ed] its previous order" and "worked to the significant prejudice of Wells Fargo." *Wells Fargo Bank of Texas*, 444 F.3d at 695-96 & n.4. The court of appeals reasoned that the bankruptcy court, by granting the motion to lift the stay, and Sommers, by agreeing to it, "explicitly authorized and consented to Wells Fargo's pursuit of state court remedies against Peerbhai." The court of appeals said this was a "green light" for Wells Fargo, who spent time and money pursuing claims against Peerbhai, only to have the order of substantive consolidation nullify the liens Peerbhai granted to

Wells Fargo in the parties' settlement. The court of appeals said that "when Sommers later filed his motion for substantive consolidation . . . he then sought to undo what he had earlier specifically authorized . . ." *Id.* at 695. The court thus held that Sommer's agreement to allow modification of the stay, coupled with Wells Fargo's pursuit of its remedies, worked an estoppel that prevented Sommers from challenging under bankruptcy law the settlement Wells Fargo had later obtained.[1]

The Fourth Circuit reasoned similarly in *County Fuel Co. v. Equitable Bank Corp.*, 832 F.2d 290 (4th Cir. 1987). In that case, the bankruptcy court had dismissed a debtor's state-court claim against a secured creditor based on *res judicata* grounds. Affirming the dismissal, the court reasoned the debtor's claim was barred by *res judicata*. The court stated that the debtor's failure to

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[1] One finds similar reasoning in the Fifth Circuit in the district court case of *Jefferson v. Mississippi Gulf Coast YMCA, Inc.*, 73 B.R. 179 (S.D. Miss. 1986), where the court had to consider whether a debtor could file an adversary proceeding after the bankruptcy court had issued an order to lift the automatic stay. The court of appeals held "that the lower court's determinations under the law that . . . the Order Lifting the Automatic Stay in appellant's second filing . . . constituted res judicata (or collateral estoppel) [were] correct." *Id.* at 181. The of appeals court stated "[t]he lower court's decision to lift the automatic stay . . . was an act within the discretion of the bankruptcy judge . . . ." *Id.* at 182. The court of appeals further stated that to allow "the debtors to effectively circumvent the effects of the Order Lifting the Automatic Stay by voluntarily dismissing their own bankruptcy and filing a new bankruptcy shortly thereafter would have amounted to a condonation of appellant's attempts to thwart the purposes" of modifying the automatic stay. *Id.*

object or to assert a counterclaim in the bankruptcy proceeding, followed by the creditor's satisfaction of the principal amount of its claim after the stay was modified, as well as the debtor's express concession of the validity of the claim in objecting to the creditor's claim for attorney's fees, sufficed to preclude the debtor's state-court action. *Id.* at 293. Although the court noted that an order modifying the stay should not be considered a final judgment on the merits that would have preclusive effect, the court said that such an order, coupled with the creditor's actions based on the order and the debtor's failure to object to the claim, was properly assigned preclusive effect. *Id.*

B. Giving Preclusive Effect to an Order Modifying the Automatic Stay Contradicts Bankruptcy Statutes and Policy.

The above discussion shows that the court of appeals' decision in the present case represents the minority view on this point. There are sound reasons for this Court to address the issues presented and to adopt the majority view.

1. That an order modifying the stay has preclusive effect is not warranted by the statutory language.

First, there is no hint from the statute's language that an order to modify the automatic stay has or should have preclusive effect on bankruptcy remedies. Section 362(d) of the Code provides that the bankruptcy court can modify the automatic stay in certain circumstances. See 11 U.S.C.A. § 362(d) (West

2004 & Supp. 2006) [*supra* pp. 2-3]. Since the bankruptcy court decided this case, section 362(d) has been amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 2005 U.S.C.C.A.N. (119 Stat.) 23 (codified throughout 11 U.S.C.). But the statute—both then and now—never gave a hint that an order modifying the stay was to have the preclusive effect that the court of appeals gave it here.

The present statute provides that a bankruptcy court may modify or terminate the stay "for cause" or, with respect to a stay of an act against property, if the debtor has no equity in the property and the property is unnecessary for an effective reorganization. *See* 11 U.S.C.A. § 362(d)(1), (2) (West 2004 & Supp. 2006). The recent amendments add additional provisions for modifying a stay with respect to actions against real estate. *Id.* § 362(d)(3), (4). Only in subsection (4), which permits recording the lift-stay order under state property record laws, does language suggest that the order has preclusive effect (on future proceedings in the bankruptcy case)—and the statute provides that a debtor in a subsequent case may have the order set aside "upon changed circumstances or for good cause shown." *Id.* § 362(d)(4). As one court put it: "That the statute sets forth certain grounds for relief and no others indicates Congress' intent that the issues decided by a bankruptcy court on a creditor's motion to lift the stay be limited to these matters" and not be deemed to have finally resolved other matters. *Grella v. Salem Five Cent Savings Bank*, 42 F.3d at 29.

In addition, the language of section 362(e) shows that Congress anticipated a summary proceeding for resolving a request for relief from the automatic stay. If no hearing is held within 30 days of a request, the stay is terminated with respect to the party requesting relief unless the court continues the stay until a final hearing—which itself must be concluded within 30 additional days. *Id.* § 362(e)(1). The matter must be concluded within 60 days in cases where the debtor is an individual. *Id.* § 362(e)(1).

The short time that section 362(e) imposes for resolving the matter conforms with holdings discussed above that the proceedings "are meant to be summary in character" and thus should not be given preclusive effect as a final adjudication on the merits. *See, e.g., Vitreous Steel Products Co. v. Miller,* 911 F.2d at 1232; *Grella v. Salem Five Cent Savings Bank,* 42 F.3d at 32.

2. *Congress's intent was to keep the proceeding to lift the automatic stay a summary proceeding.*

Second, giving no preclusive effect to a lift-stay order conforms with Congressional policy behind the statute. The relevant legislative history states that "the purpose of the automatic stay . . . is protection of the debtor and his estate from his creditors." S. Rep. No. 95-989, at 52 (1978) *reprinted in* 1978 U.S.C.C.A.N. 5787, 5838 (emphasis added). Congress believed that the "expedited hearing" for which section 362(e) provides "will not be the appropriate time at which to bring in other issues, such as counterclaims against the creditor, which, although relevant to the question of the amount of the debt, concern largely collateral or unrelated matters . . . Those counterclaims are not to be handled

in the summary fashion that the preliminary hearing under this provision will be. Rather, *they will be the subject of more complete proceedings by the trustee to recover property of the estate or to object to the allowance of a claim.* However, this would not preclude the party seeking continuance of the stay from presenting evidence on the existence of claims which the court may consider in exercising its discretion [whether to modify the stay]. *What is precluded is a determination of such collateral claims on the merits at the hearing.*" S. Rep. No. 95-989, at 55 (1978) *reprinted in* 1978 U.S.C.C.A.N. 5787, 5841 (emphasis added).

In short, Congress intended that the hearing on the motion to lift the stay would *not* be the place for the bankruptcy trustee to raise claims against the creditor seeking relief from the automatic stay, and that those matters would be reserved for later proceedings—such as occurred in this case. If "what is precluded" at the hearing to lift the automatic stay "is a determination . . . on the merits" of claims against the creditor seeking relief from the stay, then an order that modifies the stay (and any agreement not to oppose such an order) cannot preclude such claims later in the bankruptcy case.

Congress believed that "it is important that the trustee have an opportunity to inventory the debtor's position before proceeding with the administration of the case." By granting the bankruptcy court power to lift the stay, the statute works "to permit proceedings to continue in their place of origin" so as "to relieve the bankruptcy court from many duties that may be handled elsewhere." H.R. Rep. No. 95-595, at 341 (1977), *reprinted in* 19[illegible] U.S.C.C.A.N. 5963, 6297.

Congress recognized, too, that relief from the stay did not guarantee the creditor a recovery: "Though the creditor might not be able to retain his lien upon the specific collateral held at the time of filing, the purpose of the section is to insure that the secured creditor receives the value for which he bargained." *Id.*

The court of appeals' decision in the present case runs squarely against the thrust of the legislative history behind the provision in sections 362(d) and (e) for the lifting of an automatic stay.

3. *Assigning preclusive effect to orders modifying the automatic stay is bad bankruptcy policy.*

The drawing of adverse inferences from a parties' agreement to modifying the automatic stay is simply bad bankruptcy policy. As is discussed above, modifying the automatic stay is a vital tool created by Congress for use in bankruptcy proceedings. It allows claims to be liquidated in a separate proceeding and thereby provides certainty as to the amount of claims—without the unnecessary expense of time and effort, early in the bankruptcy case, determining a creditor's rights *vis-à-vis* the estate.

In addition, under fear that they may be giving away substantive rights under bankruptcy law, parties may hesitate to agree to modify the stay, thereby creating unnecessary procedural disputes. Parties in interest should not be under the threat that an agreement to modify the stay will be raised as an estoppel in future bankruptcy proceedings. A request to modify the stay usually occurs so early in the

bankruptcy case that parties have not done sufficient investigation or discovery to reasonably know or anticipate whether the proceeding for which the stay is modified might, if given conclusive effect, adversely affect the party's interests.

Similarly, the court of appeals' decision may discourage courts from modifying a stay, under the threat that issuance of such an order will preclude bankruptcy remedies against the creditor seeking relief, or will preclude relief regarding what is later determined to be property of the estate under the Bankruptcy Code.

In this case, the court of appeals decided that the trustee's agreement to a modification of the stay precluded the subsequent remedy of substantive consolidation. But the court of appeals' decision that an agreement to lift the stay can bar the trustee from contesting the results of the proceeding for which the stay is lifted could adversely affect a trustee's ability to pursue statutory remedies expressly authorized by the Bankruptcy Code or state statute—such as actions for fraudulent transfer or actions to recover a preference. *See* 11 U.S.C.A. §§ 547, 548 (West 2004 & Supp. 2006). If an agreement to modify the stay gives a party in interest a "green light" to proceed against a debtor or related party, should the agreement bar a subsequent action against the creditor to recover a fraudulent transfer or a preference? Nothing in the case law or the language of the Bankruptcy Code (in section 362 or elsewhere) indicates that an order modifying the automatic stay should adversely effect claims against the creditor or other substantive rights under the Bankruptcy Code or other state and federal law.

4. *Wells Fargo knew that it was taking liens on Peerbhai's real estate paid for with AIA's assets.*

Contrary to the court of appeals conclusions in the present case, the bankruptcy court's order of substantive consolidation *nunc pro tunc* did no unfair harm to Wells Fargo. As noted above, Wells Fargo knew good and well what it was doing when, settling its claims against Peerbhai, it took liens on Peerbhai's real estate—for which the mortages had been paid off using proceeds from the sale of AIA's assets. It did not rely on the lift-stay order as a "green light" for pursuing its legitimate claims against Peerbhai.

Rather, Wells Fargo relied on its knowledge of what Peerbhai had done and its awareness that, as the AIA bankruptcy proceeded, the trustee and AIA's creditors were getting wise about what Peerbhai had done with AIA's assets. That is what the bankruptcy court meant when it found that Wells Fargo did not rely on the separate credit of Peerbhai, AIA, or Group, and when the court expressly took account of "Wells Fargo's knowledge and the circumstances surrounding the execution of the Limited Forbearance Agreement . . ." (R. 169). The court meant that Wells Fargo was "gaming the system."

When Wells Fargo executed the Limited Forbearance Agreement, Wells Fargo knew that Peerbhai had acquired the $1.5 million proceeds from the transfer of AIA's assets and had used most of the proceeds to satisfy Peerbhai's personal real estate debts (R. 340-47). When, early in 2002, Wells Fargo asked Peerbhai to explain what happened to the money he received from the sale of AIA's remaining assets,

Peerbhai supplied a chart reflecting that most of the sales proceeds were applied to the mortgages on his personal real estate holdings—and those real estate holdings were then pledged to Wells Fargo under the Limited Forbearance Agreement (Trustee Ex. 144). Peerbhai resisted disclosing this information at a creditors' meetings—and indeed abruptly terminated the meeting when creditors began questioning AIA's expenditures on Peerbhai's behalf (R. 214-16). Right after that that meeting, Peerbhai and Wells Fargo signed the Limited Forbearance Agreement (R. 215; Wells Fargo Ex. 20), with knowledge regarding the source of the funds.

Thus, in setting with Peerbhai, Wells Fargo knowingly took liens on properties whose mortgages Peerbhai had recently reduced using funds from AIA's assets—all of which Wells Fargo knew. The court of appeals was wrong, therefore, to set aside (without a challenge from Wells Fargo) the bankruptcy court's fact finding that substantive consolidation was fair in the light of "Wells Fargo's knowledge and the circumstances surrounding the execution of the Limited Forbearance Agreement."

When Wells Fargo asked the bankruptcy court to modify the automatic stay so that Wells Fargo could pursue its state court lawsuit against Peerbhai, all the bankruptcy court needed to consider at that point was whether Wells Fargo had a colorable claim as to Peerbhai's property. Section 362(d) did not require the court or Sommers, as trustee, to take discovery on Wells Fargo's knowledge or intent in pursuing that lawsuit. Nothing in the language of section 362(d) or the precedent interpreting it would have allowed that.

It is thus contrary to the Bankruptcy Code to suggest that Sommers should have considered that his agreement not to oppose a modification of the stay might later bar him from pursuing remedies against Wells Fargo on behalf of AIA's estate if it turned out that Wells Fargo was gaming the system.

CONCLUSION

A conflict exists among the circuits on whether a bankruptcy court's order modifying the automatic stay can bar bankruptcy law remedies regarding the subject matter of claims that the order allowed to proceed. The court of appeals' decision here gives estoppel effect to such an order, and that is contrary to Congress' intent and the language of the Bankruptcy Code. Sommers therefore asks this court to grant this petition and reverse the court of appeals' decision.

Respectfully submitted,

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Supreme Court, U.S.
FILED
JUL 31 2006
OFFICE OF THE CLERK

No. 06-172

In the
SUPREME COURT OF THE UNITED STATES

RONALD J. SOMMERS, TRUSTEE,
Petitioner,
v.
WELLS FARGO BANK OF TEXAS, N.A.,
Respondent.

On Petition For A Writ of Certiorari to the
United States Court of Appeals for the Fifth Circuit

Appendix to Petition for Writ of Certiorari

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TABLE OF CONTENTS

Wells Fargo Bank of Texas, N.A. v. Sommers, Trustee, 444 F.3d 690 (5th Cir. 2006) 1

Wells Fargo Bank of Texas, N.A. v. Sommers, Trustee, No. 4:04-CV-455 (S.D. Tex. Sept. 6, 2004) (order)..... 15

Wells Fargo Bank of Texas, N.A. v. Sommers, Trustee, No. 4:04-CV-455 (S.D. Tex. Sept. 6, 2004) (judgment) .. 32

In re Amco Insurance Agencies, Inc., No. 02-31265-H5-7 (Bankr. S.D. Tex. Sept. 25, 2003) (findings of fact)..... 33

In re Amco Insurance Agencies, Inc., No. 02-31265-H5-7 (Bankr. S.D. Tex. Nov. 19, 2003) (order)..... 63

Wells Fargo Bank of Texas, N.A. v. Sommers, Trustee, No. 04-20841 (5th Cir. May 4, 2006) (on petition for rehearing)..... 68

11 U.S.C.A. § 362(d) (West 2004 & Supp. 2006)..... 70

No. 04-20841

IN THE UNITED STATES COURT OF APPEALS,
FOR THE FIFTH CIRCUIT

In the Matter of AMCO INSURANCE; Rehmat PEERBHAI, Debtors.
Wells Fargo Bank of Texas N.A., Appellant,
v.
Ronald J. SOMMERS, Trustee; Amco Insurance; Rehmat Peerbhai, Appellees.

March 31, 2006.
Rehearing Denied May 4, 2006.

Before JOLLY, DENNIS and OWEN, Circuit Judges.
JOLLY, Circuit Judge:

The significance of this bankruptcy case relates to the *nunc pro tunc* substantive consolidation of the assets and liabilities of a corporation in bankruptcy and its sole shareholder, not in bankruptcy (until afterwards). Because the bankruptcy court's *nunc pro tunc* order was an abuse of discretion under the facts of this case, we vacate the district court's order and remand.

I.

Rehmat A. Peerbhai, an entrepreneur in the automobile industry, owned and managed AIG, a holding company in the automobile insurance business, prior to 1992.[1] On April 21, 1992, Peerbhai incorporated a new company, AIA, which sells automobile insurance. A parent-subsidiary relationship was formed between AIG, as parent, and AIA, as subsidiary, with Peerbhai acting as the sole owner of both companies. AIG, AIA, and Peerbhai are all debtors in bankruptcy proceedings that are at issue in this appeal.

In September 2000, Peerbhai, in his individual capacity, and AIG approached Wells Fargo for financing, and Wells Fargo agreed to enter into loan transactions with both. However, Wells Fargo required Peerbhai, AIG, and AIA to be independently audited by PricewaterhouseCoopers and Belew Averitt LLP before granting the loans. After reviewing the financial statements and audit reports, Wells Fargo agreed to lend money to Peerbhai as an individual, and to AIG. Wells Fargo extended a loan in the amount of $2.4 million to Peerbhai and AIG as co-borrowers, and another loan in the amount of $1.2 million to AIG. Wells Fargo required Peerbhai personally to guarantee AIG's corporate obligations, and Peerbhai executed a Continuing Guaranty on September 21, 2000.

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[1] This recitation of the facts is taken largely from the district court's opinion.

In December 2001, AIG breached a material loan covenant with Wells Fargo. On January 10, 2002, Wells Fargo filed, in state court, an Original Petition and Restraining Order against AIG based on this breach. AIA and AIG both filed petitions for bankruptcy under Chapter 7 of the Bankruptcy Code on February 4, 2002. On February 11, Wells Fargo filed a Motion to Lift Stay to Pursue State Court Litigation in the AIG bankruptcy case. The bankruptcy court entered an agreed order partially lifting the automatic stay on March 14, expressly permitting Wells Fargo to pursue state court remedies against Peerbhai individually. Wells Fargo began collection activities against Peerbhai, and thereafter Peerbhai requested that Wells Fargo forbear from exercising its legal and contractual rights and remedies until April 9, 2003. Wells Fargo and Peerbhai reached an agreement and executed a Limited Forbearance Agreement dated April 10, 2002, and they filed an Agreed Judgment settling the state court litigation. The state court entered the Agreed State Court Judgment on April 25, 2002, giving Wells Fargo a consensual lien on Peerbhai's homestead, as well as a judgment against Peerbhai pursuant to the terms of Peerbhai's Continuing Guaranty. The total amount of the Agreed State Court Judgment against Peerbhai was $3,398,956.16.

II.

On July 11, 2002, the Trustee for AIA, Ronald J. Sommers, filed an Application for Substantive

Consolidation ("Application"), seeking to consolidate AIA and Peerbhai as a single debtor in bankruptcy. At the time of the Application, Peerbhai was not in bankruptcy, and the Application sought essentially to put him into bankruptcy and relate his filing date back to AIA's February 4, 2002 filing date under the theories of "single economic unit" and "single business enterprise." Wells Fargo objected to the Application. On December 11, 2002, Peerbhai filed a Chapter 11 bankruptcy petition, which he later converted into a Chapter 7 petition.

The United States Bankruptcy Court for the Southern District of Texas held evidentiary hearings on the Application on May 2 and May 23, 2003. Sommers argued that Peerbhai and AIA were not separate legal entities, and that the finances of AIA and AIG were commingled by Peerbhai so that substantively consolidating all of Peerbhai's personal assets with the assets of AIA and AIG was the only way to ensure equitable distribution of the assets to the creditors of AIA and AIG.

On September 25, 2003, the bankruptcy court issued Findings of Fact and Conclusions of Law. It determined that Peerbhai engaged in a pattern of activity that was aimed at concealing AIA's proceeds from its creditors and from Peerbhai's personal creditors, that Peerbhai made no meaningful distinction between his funds and those of AIA while AIA was a going concern, that substantial identity between Peerbhai and AIA existed and AIA's creditors dealt

with Peerbhai and AIA as a single economic unit and did not rely on their separate identities in extending credit, that Peerbhai and AIA did not observe the corporate formalities required by Texas law, and that Peerbhai treated AIA as an alter ego of himself, using the AIA corporate status to commit fraud against his and AIA's creditors. Based on these findings, the bankruptcy court concluded that substantive consolidation was appropriate for several reasons: first, substantive consolidation would benefit all creditors, and not unfairly prejudice any creditor, because the financial affairs of AIA and Peerbhai were so entangled that the assets of each could not be segregated; second, substantive consolidation would avoid the harm of AIA's creditors receiving virtually nothing in a bankruptcy that was caused primarily by Peerbhai looting AIA; third, Wells Fargo would not be unfairly harmed by substantive consolidation because of Wells Fargo's knowledge and the circumstances surrounding the execution of the Limited Forbearance Agreement, and further that any prejudice Wells Fargo may suffer from substantive consolidation is not unfair, and is substantially outweighed by the benefits to other creditors; fourth, the fact that AIA and Peerbhai were essentially a single financial entity could not have been ignored by Wells Fargo or any other reasonably diligent party extending credit to Peerbhai; and fifth, substantive consolidation should be effective *nunc pro tunc* to the petition date of February 4, 2002, because at all relevant times, Peerbhai and AIA operated as one financial entity.

Wells Fargo appealed to the district court the bankruptcy court's November 17, 2003 Order Granting Substantive Consolidation. In that appeal, Wells Fargo argued for the first time that the Supreme Court of the United States effectively abrogated the doctrine of substantive consolidation in *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, which held that a preliminary injunction, issued prior to any judgment essentially to prevent fraudulent transfer of assets, was an improper use of equity powers. 527 U.S. 308, 332, 119 S.Ct. 1961, 144 L.Ed.2d 319 (1999) ("[T]he equitable powers conferred by the Judiciary Act of 1789 did not include the power to create remedies previously unknown to equity jurisprudence. Even when sitting as a court in equity, we have no authority to craft a 'nuclear weapon' of the law like the one advocated here."). The district court, however, determined that substantive consolidation remains an available remedy despite the *Grupo Mexicano* holding, reading *Grupo Mexicano* narrowly and noting that *Grupo Mexicano* did not discuss the remedy of substantive consolidation.

Wells Fargo further argued that even if substantive consolidation is an available remedy, the bankruptcy court should not have applied it retrospectively to revoke Wells Fargo's interests in Peerbhai's assets. The district court noted that before a court may exercise its *nunc pro tunc* powers, that court must make an inquiry to determine whether retroactivity is necessary to achieve some benefit or avoid harm. The district court determined that the

bankruptcy court took the proper factors into consideration in determining whether to apply substantive consolidation retroactively, and thus its decision was appropriate.

Wells Fargo made a third argument to the effect that the bankruptcy court's alter ego conclusion was improper under Texas law, which requires proof of actual fraud. Wells Fargo contended that the bankruptcy court did not show that Peerbhai had the actual intent necessary to prove actual fraud. The district court held that based on the bankruptcy court's findings, the actions of Peerbhai prove that his intent to defraud was calculated, not accidental, and thus the bankruptcy court's decision regarding alter ego was not erroneous.

Wells Fargo timely appeals the district court's final judgment.

III.

Wells Fargo argues that the bankruptcy court did not have the power to order substantive consolidation and, in the alternative, that if the bankruptcy court had such power, it applied the wrong standard to determine whether substantive consolidation was appropriate. Further, Wells Fargo contends that substantive consolidation was inappropriate in this case and, finally, that the bankruptcy court erred in issuing the order to consolidate *nunc pro tunc*.

This Court applies the same standard of review to the bankruptcy court's decision as applied by the district court. *Total Minatome Corp. v. Jack/Wade Drilling, Inc. (In re Jack/Wade Drilling, Inc.)*, 258 F.3d 385, 387 (5th Cir. 2001). The bankruptcy court's findings of fact are reviewed under a clear error standard, while conclusions of law are reviewed *de novo*. *Id.* The determination of which standard to apply in order to assess whether substantive consolidation is appropriate is a question of law reviewed *de novo*. As to the bankruptcy court's decision to consolidate, some courts suggest that we review such decision under an abuse of discretion standard. *See, e.g., Reider v. Fed. Deposit Ins. Corp. (In re Reider)*, 31 F.3d 1102, 1105 (11th Cir. 994) (applying abuse of discretion standard to bankruptcy court's decision to consolidate estates of spouses, as explicitly authorized under the Bankruptcy Code); *First Nat'l Bank of El Dorado v. Giller (In re Giller)*, 962 F.2d 796, 799 (8th Cir. 1992) (stating that the abuse of discretion standard may be appropriate, but declining to resolve the question). This Court has stated that "substantive consolidation affects the substantive rights of the parties and therefore is subject to heightened judicial scrutiny." *Clyde Bergemann, Inc. v. Babcock & Wilcox Co. (In re Babcock & Wilcox Co.)*, 250 F.3d 955, 959 n. 6 (5th Cir. 2001). Furthermore, we review the bankruptcy court's decision to enter a *nunc pro tunc* order for abuse of discretion. *See Heartland Fed. Sav. & Loan Ass'n v. Briscoe Enters., Ltd., II (In re Briscoe Enterprises, Ltd., II)*, 994 F.2d 1160, 1170 (5th Cir. 1993);

see also Pac. Shores Dev., LLC v. At Home Corp. (In re At Home Corp.), 392 F.3d 1064, 1067 (9th Cir. 2004).

On March 14, 2002, the bankruptcy court entered an Agreed Order Partially Lifting the Automatic Stay to Proceed in State Court Litigation ("Agreed Order"). This order granted Wells Fargo's "Emergency Motion to Lift the Automatic Stay to proceed in the lawsuit [in state court] ..., to maintain its temporary injunction against [AIG] and pursue remedies against [ ] Peerbhai, individually[.]" Sommers and Wells Fargo both consented to the Agreed Order. The bankruptcy court, by granting the motion to lift the stay, and Sommers, by agreeing to it, explicitly authorized and consented to Wells Fargo's pursuit of state court remedies against Peerbhai. Because of this green light by the bankruptcy court, Wells Fargo expended its time and money to pursue the state court litigation until the suit concluded in the Limited Forbearance Agreement. Yet, when Sommers later filed his motion for substantive consolidation, which the bankruptcy court in turn granted, he then sought to undo what he had earlier specifically authorized by applying the consolidation of the estates *nunc pro tunc*. In granting the motion, the bankruptcy court stated that "[t]he avoidance of the liens granted to Wells Fargo by Peerbhai pursuant to the Limited Forbearance Agreement would simply return Wells Fargo to its position as of the petition date." We think it was a little late for this reversal of course.

The bankruptcy court, in granting Wells Fargo authorization to pursue the state court litigation, and then invalidating its authorization some twenty months later, and nineteen months after the litigation had terminated in a settlement, cited Section 105(a) of the Bankruptcy Code as its jurisdictional authority.[2] However, "[a] court's powers under § 105(a) are not unlimited[.]" *Mirant Corp. v. Potomac Elec. Power Co. (In re Mirant Corp.)*, 378 F.3d 511, 523 (5th Cir. 2004). Section 105(a) "does not permit [ ] courts to 'act as roving commission[s] to do equity.'" *Id.* (quoting *In re Southmark Corp.*, 49 F.3d 1111, 1116 (5th Cir. 1995)) (second alteration in original).[3] But even if the

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[2] The provision granting the bankruptcy court its general equitable powers states that:

> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

11 U.S.C. § 105(a) (2005).

[3] We also note concerns regarding the consolidation of a non-debtor with a debtor, which is the essence of what the *nunc pro tunc* nature of the order granting substantive consolidation achieved. "The courts are

divided on whether they may order consolidation of a debtor with a nondebtor." 2 Collier on Bankruptcy ¶ 105.09[1][c] (15th ed. rev. 2005). Some courts have allowed such consolidation. *See, e.g., Soviero v. Franklin Nat'l Bank*, 328 F.2d 446 (2d Cir. 1964); *Walter E. Heller & Co. v. Langenkamp (In re Tureaud)*, 59 B.R. 973 (N.D. Okla. 1986). Others have cautioned that "as careful as the courts must be in allowing substantive consolidation of *debtors* to occur ..., the caution must be multiplied exponentially in a situation where a consolidation of a debtor's case with a non-debtor is attempted." *Morse Operations, Inc. v. Robins Le-Cocq, Inc. (In re Lease-A-Fleet, Inc.)*, 141 B.R. 869, 872 (1992). Still others have held that the bankruptcy court does not have subject matter jurisdiction over a non-debtor, thus precluding substantive consolidation, as § 105 of the Bankruptcy Code is not a jurisdictional grant, and further that substantive consolidation should not be used to circumvent the involuntary bankruptcy petition procedures of § 303 of the Bankruptcy Code. *Helena Chem. Co. v. Circle Land & Cattle Corp. (In re Circle Land & Cattle Corp.)*, 213 B.R. 870, 876-77 (Bankr.D.Kan.1997).

In this case, Peerbhai was a non-debtor on February 4, 2002, the date to which the bankruptcy court determined in its *nunc pro tunc* order that substantive consolidation relates. Peerbhai did not file his own bankruptcy petition for another ten months after the petition date of AIA and AIG, and five months after Sommers filed the Application for Substantive Consolidation. Because Peerbhai was a non-debtor for

bankruptcy court had the jurisdictional authority, it abused its discretion in exerting it. Furthermore, we think that the trustee, Sommers, should have been more circumspect in requesting such an order given his earlier approval of the litigation that resulted in settlement terms that could not have been unexpected. Wells Fargo relied on the agreement of the trustee and the approval of the court when it lifted the stay, and Wells Fargo made investments of its time and money because of this specific approval. Furthermore, nothing in the record suggests that Sommers knew anything more at the later date when he asked the court to grant substantive consolidation than he could have reasonably known at the time the Agreed Order was entered. This untimely withdrawal of approval might have been understood if the litigation had produced some anomalous and unexpected result, but it did not. On the other hand, the abrogation of the earlier approval worked to the significant prejudice of Wells Fargo.[4]

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such a substantial amount of the relevant time, special concerns exist. Substantive consolidation should be ordered with more caution than normal, and jurisdictional concerns may also be at issue.

[4] This abrogation also seems to be in tension with Section 105(a), which allows the court to *sua sponte* take action to enforce or implement its orders. In this case, the bankruptcy court appears to use its Section 105(a) powers to contradict its previous order.

Because we hold that the bankruptcy court erred in applying substantive consolidation *nunc pro tunc*, and thus vacate and remand for further proceedings, we decline to address Wells Fargo's arguments regarding the bankruptcy court's power to grant substantive consolidation and the proper standard for and application of substantive consolidation.[5] Given

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[5] Without deciding whether the bankruptcy court has the power to order substantive consolidation, we do note that those jurisdictions that have allowed it emphasize that substantive consolidation should be used "sparingly." *In re Owens Corning*, 419 F.3d 195, 208-09 (3d Cir.2005); *In re Bonham*, 229 F.3d 750, 767 (9th Cir.2000); *Union Sav. Bank v. Augie/Restivo Baking Co. (In re Augie/Restivo Baking Co.)*, 860 F.2d 515, 518 (2d Cir.1988); 2 Collier on Bankruptcy ¶ 105.09[1][d] (15th ed. rev.2005). It "is an extreme and unusual remedy." *Gandy v. Gandy (In re Gandy)*, 299 F.3d 489, 499 (5th Cir.2002). "Indeed, because substantive consolidation is extreme ... and imprecise, this 'rough justice' remedy should be rare and, in any event, one of last resort after considering and rejecting other remedies." *Owens Corning*, 419 F.3d at 211. Furthermore, it appears on the record before us that other remedies, such as the doctrines of alter ego and fraudulent conveyance, may have been available, and appropriate under the circumstances, and the bankruptcy court should duly make such considerations. Substantive consolidation should not be used as "a 'free pass' to spare [d]ebtors or any other group from proving challenges, like

that the order of substantive consolidation, in the absence of a *nunc pro tunc* order, appears likely to be fruitless, there is the probability that the issue will not arise on remand.

IV.

For the reasons stated, the judgment of the district court is VACATED, and the case is REMANDED for further proceedings consistent with this opinion.

VACATED and REMANDED.

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fraudulent transfer claims, that are liberally brandished to scare yet are hard to show." *Owens Corning*, 419 F.3d at 215. As the *Owens Corning* court noted, if the objectors to substantive consolidation were as vulnerable to the fraudulent transfer challenges as alleged, "then the game should be played to the finish in that arena." *Id.*

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

WELLS FARGO BANK TEXAS, N.A.	§	
Appellant,	§	
versus	§	C.A. NO. H-04-0455
RONALD J. SOMMERS, et al.	§	[entered Sept. 6, 2004]
Appellees.	§	

ORDER

Pending before the Court is Appellant Wells Fargo's appeal from the bankruptcy court's order of November 17, 2003. (Instrument No. 2, at 1).

I.

The debtor, Mr. Rehmat A. Peerbhai ("Peerbhai") was an entrepreneur in the automobile insurance industry. (Instrument No. 10, Appendix 1, at 2-3). Prior to 1992, Mr. Peerbhai owned and managed one business entity, Amco Insurance Group ("AIG"). (Id.). On April 21, 1992, Mr. Peerbhai incorporated a new company, Amco Insurance Agency ("AIA") as a subsidiary of AIG. (Id. at 2). AIA acted as a general agent for the administration of various insurance

programs under a license issued by the Department of Insurance for the State of Texas. (Id.). A parent-subsidiary relationship was formed between AIG and AIA, and Mr. Peerbhai acted as the sole owner of both companies. (Id.). Both AIG and AIA are also debtors in the bankruptcy proceedings at issue in this appeal.

In September of 2000, Mr. Peerbhai, in his individual capacity, and AIG approached Wells Fargo for financing. (Instrument No. 9, at 4). Wells Fargo agreed to enter into loan transactions with both Mr. Peerbhai and AIG. (Id.). Before granting the loan, Wells Fargo required Mr. Peerbhai, AIG, and AIA to be independently audited by PricewaterhouseCoopers ("PwC") and Belew Averitt LLP (now known as BDO Seidman). (Id.). After reviewing the financial statements and audit reports, Wells Fargo agreed to lend money to Mr. Peerbhai as an individual, and to AIG as a corporation. (Id.). On September 21 , 2000, Mr. Peerbhai became personally indebted to Wells Fargo in the amount of $2.4 million and to AIG in the amount of $1.2 million. (Id.). In addition to requiring collateral to secure the loans, Wells Fargo required Mr. Peerbhai to personally guarantee AIG's corporate obligations. (Id.). Mr. Peerbhai executed a Continuing Guaranty dated September 21, 2000, making Wells Fargo the only creditor with a Continuing Guaranty. (Id.).

In December of 2001, AIG breached a material loan covenant with Wells Fargo. (Instrument No. 9, at 5). Based on this breach, Wells Fargo filed an Original Petition and Restraining Order against AIG on January

10, 2002 in the United States Bankruptcy Court for the Southern District of Texas. (Id.). On February 4, 2002, both AIA and AIG filed petitions for bankruptcy under Chapter 7 of Title 11 of the bankruptcy court. (Id.).

On February 11, 2002, Wells Fargo filed a Motion to Lift Stay to Pursue State Court Litigation ("Lift Stay Motion") in the AIG bankruptcy case. (Instrument No. 9, at 5). Wells Fargo sought to enforce its Continuing Guaranty against Mr. Peerbhai individually. (Id.). Wells Fargo pursued Mr. Peerbhai because he personally guaranteed the Continuing Guaranty. (Instrument No. 9, at 4). On March 14, 2002, the bankruptcy court entered an order partially lifting the automatic stay that expressly permitted Wells Fargo to pursue state court remedies against Mr. Peerbhai, individually. (Instrument No. 9, at 5). Wells Fargo initiated collection activities against Mr. Peerbhai. (Id.). Mr. Peerbhai then requested that Wells Fargo forbear from exercising its legal and contractual rights and remedies until April 9, 2003. (Id.). The parties reached an agreement and executed a Limited Forbearance Agreement dated April 10, 2002. (Id. at 6).

As contemplated in the Litigation Lift Stay Order issued on April 11, 2002, Wells Fargo and Mr. Peerbhai filed an Agreed Judgment ("the Agreed State Court Judgment") settling the state court litigation between Wells Fargo and Mr. Peerbhai. (Instrument No. 9, at 6). On April 25, 2002, the state court entered the Agreed State Court Judgment pursuant to which Wells Fargo received a consensual Lien on Mr. Peerbhai's homestead in the amount of $870,669.84.

(Id.). In addition to the homestead lien, Wells Fargo received a judgment against Mr. Peerbhai pursuant to the terms of Mr. Peerbhai's Continuing Guaranty. (Id.). The total amount of the Agreed State Court Judgment against Mr. Peerbhai was $3,398,956.16. (Id.). Mr. Peerbhai also represented that he, personally, owned additional real estate. Mr. Peerbhai pledged other, separate assets to Wells Fargo as collateral to secure his obligations under the Continuing Guaranty. (Id.).

On May 2 and May 23, 2003, the United States Bankruptcy Court for the Southern District of Texas held evidentiary hearings on an Application for Substantive Consolidation filed by Ronald J. Sommers ("Sommers"), the Chapter 7 Trustee for debtors AIA, and Mr. Peerbhai. (Instrument No. 10, Appendix 1, at 19). The Trustee sought to substantively consolidate AIA's estate with that of Mr. Peerbhai. (Id.). In effect, this would place Mr. Peerbhai in bankruptcy as of February 4, 2002 under the theories of "single economic unit" and "single business enterprise." (Instrument No. 9, at 7). As noted above, AIA and AIG were both owned by Mr. Peerbhai. (Id. at 4). At trial, Mr. Sommers attempted to show that Mr. Peerbhai and AIA were not separate legal entities. (Instrument No. 9, at 7). The Trustee believed that the finances of AIA and AIG were commingled by Mr. Peerbhai such that the only way to ensure equitable distribution of assets amongst the creditors of AIA and AIG would be to substantively consolidate all of Mr. Peerbhai's personal assets with the assets of AIA and AIG. (Instrument No. 10, at 5).

Upon hearing the evidence presented, the bankruptcy court made the following determinations: First, the bankruptcy court determined that Mr. Peerbhai engaged in a pattern of activity aimed at concealing proceeds from the operations and sale of AIA assets from both AIA's creditors and Mr. Peerbhai's personal creditors. (Instrument No. 10, Appendix 1, at 16-17). Second, Mr. Peerbhai made no meaningful distinction between his personal funds and AIA's while AIA was a commercial enterprise engaging in business. (Id. at 19). Third, the creditors of AIA dealt with Mr. Peerbhai and AIA as a single economic unit and did not rely on their separate identity in extending credit. (Id. at 20). Fourth, Mr. Peerbhai treated AIA as an alter ego and used the AIA corporate status to commit fraud against his personal creditors and AIA's creditors. (Id. at 21). Fifth, Mr. Peerbhai and AIA did not observe corporate formalities required by Texas law. (Id.).

Based on the above findings, the bankruptcy court made the following conclusions: First, the lack of financial records prevented the Trustee from being able to identify and segregate the affairs of AIA and Mr. Peerbhai as there was no autonomy between the finances of AIA and Mr. Peerbhai before the petition date. (Instrument No. 10, Appendix 1, at 19-20). Second, substantive consolidation will protect AIA's creditors from recovering virtually nothing in a bankruptcy that was caused largely by Mr. Peerbhai looting AIA. (Id. at 20). Third, in light of Wells Fargo's knowledge and the circumstances surrounding the

execution of the Limited Forbearance Agreement, Wells Fargo will not be unfairly harmed by substantive consolidation. (Id.). Fourth, the extent to which Mr. Peerbhai and AIA were essentially one financial entity prior to the petition date could not have been ignored by Wells Fargo or any other reasonably diligent party extending credit to Mr. Peerbhai. (Id. at 21). Fifth, the affairs of AIA and Mr. Peerbhai were so entangled, substantive consolidation of assets will be to the benefit of all creditors and no creditor will be unfairly prejudiced. (Id. at 21- 2). Sixth, substantive consolidation of Mr. Peerbhai's and AIA's assets should be effective *nunc pro tunc*, as Mr. Peerbhai and AIA acted as one financial entity during all relevant times. (Id. at 21).

On February 5, 2004, the Appellant, Wells Fargo filed this appeal against Mr. Sommers, AIA and Mr. Peerbhai from the bankruptcy court's order of November 17, 2003. (Instrument No. 2. at 1). Wells Fargo argues that the bankruptcy court exceeded its congressional and constitutional grant of authority when it issued an order for retroactive substantive consolidation of AIA's assets and Mr. Peerbhai's assets, (Instrument No. 2, at 1). Wells Fargo claims that the two accounting firms, PricewaterhouseCoopers and BDO Seidman, never found evidence that the assets belonging to Mr. Peerbhai, AIA and AIG were hopelessly or inextricably intertwined. (Instrument No. 9, at 7).

Wells Fargo contends that Mr. Charles Calvin, the loan officer responsible for the loans made,

reasonably relied on Mr. Peerbhai's representations about the Amco Companies and Mr. Peerbhai in making the loans. (Instrument No. 9, at 7). Wells Fargo also contends that, based on the evidence presented during the bankruptcy court evidentiary hearings, the Trustee failed to demonstrate that Mr. Peerbhai intended to perpetrate actual fraud on Wells Fargo or any other obligee for Mr. Peerbhai's direct personal benefit, as required by Texas Business Corporation Article 2.21. (Id. at 8).

On March 9, 2004 the Appellees make the following arguments in the Appellee's Brief. (Instrument No. 10, at 4): First, that at the time the loans were made, Mr. Calvin knew that AIA was the primary operating entity and that the source of income reflected on the financial statements belonged to AIA. (Id.). Second, that Mr. Calvin knew that income from AIA would be the primary source for repayment of the loans made to Mr. Peerbhai and AIG, and that Wells Fargo was aware that Mr. Peerbhai had a negative net worth apart from AIA. (Id.). Third, that Mr. Calvin was aware that AIG and AIA were separate corporations and that both were owned by Mr. Peerbhai. (Id.). Fourth, that Wells Fargo knew that Mr. Peerbhai had no net worth apart from his ownership in AIA and, therefore, Wells Fargo could not realistically claim that it relied on the separate credit of Mr. Peerbhai. (Id.).

II.

When reviewing a bankruptcy court's decision, the district court functions as an appellate court and applies the standard of review generally applied in the federal court of appeals. *In Re Webb*, 954 F.2d 1102, 1103-04 (5th Cir. 1992). Findings of fact, whether based on oral or documentary evidence, shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the bankruptcy court to judge the credibility of the witnesses. *Id.* at 1104. The district court must ascertain whether the evidence supports the findings of the bankruptcy judge and determine whether the district court is "left with the definite and firm conviction that a mistake has been committed." *Id.* (citing *Anderson v. City of Bessemer*, 470 U.S. 564 (1985)).

Matters of law are reviewed *de novo* by the district court. *Matter of Coston*, 987 F.2d 1096, 1099 (5th Cir. 1992), *affd on reh 'g*, 991 F.2d 257 (5th Cir. 1993). *De novo* review requires the court to make a judgment independent of the bankruptcy court's, without deference to that court's analysis and conclusions. *In Re England*, 141 B.R. 495, 497 (N.D. Tex. 1991), *aff'd*, 975 F.2d 1168 (5th Cir. 1992).

The issues in this appeal concern questions of law. The court will therefore review the issues *de novo*.

III.

A.

Wells Fargo's main contention is that in light of *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, 527 U.S. 308 (1999) ("Grupo"), the bankruptcy court erred in ordering substantive consolidation of the estates of Mr. Peerbhai and AIA. (Instrument No. 9, at 1). Wells Fargo argues that the doctrine of substantive consolidation was abrogated in the United States Supreme Court's holding in *Grupo*. (Instrument No. 9, at 8-11).

In *Grupo*, the Court offered some guidance regarding the circumstances under which lower courts may impose remedies such as preliminary injunctions on a debtor's assets. In *Grupo*, the respondent purchased unsecured notes from the petitioner, Grupo Mexicano de Desarrollo, S.A. ("GMD"), a Mexican holding company. *Grupo*, 527 U.S. at 310. Four GMD subsidiaries guaranteed the notes. *Id.* at 310. After GMD fell into financial trouble and missed an interest payment on the notes, the respondents accelerated the note's principal amount and filed the case in federal district court. *Id.* at 312. The respondents alleged that GMD was at risk of insolvency, or was already insolvent, and was showing preference to its Mexican creditors by its planned allocation of its most valuable assets to them. *Id* The respondents argued that these actions would frustrate any judgment they could obtain. The respondents requested a preliminary injunction restraining the petitioners from transferring

the assets. *Id.* The district court issued the preliminary injunction and ordered the respondents to post a $50,000 bond. *Id.* at 312-13.

The Supreme Court held that the district court had no authority to issue a preliminary injunction preventing the petitioners from disposing of their assets pending adjudication of the respondents' contract claim for money damages. *Id.* at 318-21. The Court was of the view that such a remedy was historically unavailable to a court of equity. *Id.*

With regard to the scope of authority for federal courts in bankruptcy proceedings, the Court in *Grupo* stated, "The equity jurisdiction of the federal courts is the jurisdiction in equity exercised by the High Court of Chancery in England at the time of the adoption of the Constitution and the enactment of the original Judiciary Act, 1789." *Id.* at 318 (citing, A. DOBIE, HANDBOOK OF FEDERAL JURISDICTION AND PROCEDURE 660 (1928)).

Wells Fargo thus argues that the holding in *Grupo* effectively prevents bankruptcy courts from applying remedies like substantive consolidation that were not available to the courts in 1789. (Instrument No. 9, at 10). Wells Fargo's interpretation of *Grupo* is broad and general. A liberal reading of *Grupo* may suggest that bankruptcy courts are barred from applying any remedy that was non-existent in 1789. This Court must determine whether the Court intended the holding in *Grupo* to be applied as a blanket rule or

whether *Grupo* was intended for a narrow range of cases with specific facts.

In *Grupo*, the Court determined that the respondents had not provided enough evidence for an exception to the general rule that a creditor must obtain a judgment before a debtor may be precluded from using their property. The Court stated, "Although the United States says that some of them 'might have been relevant in a case like this one,' . . . we are not inclined to speculate upon the existence or applicability to this case of any exceptions, and follow the well-established general rule that a judgment establishing the debt was necessary before a court of equity would interfere with the debtor's use of his property." *Grupo*, 527 U.S. at 320-21 (citing Brief of the United States as Amicus Curiae 11) (emphasis added). This statement suggests that the Court will allow exceptions to the general rule but only if the facts of that specific case allow for an exception.

The Court did not indicate that it intended a blanket application of its holding in *Grupo*. The Court was concerned with situations where creditors, without a valid judgment, could simply preclude debtors from using their assets for fear that nothing will be left over to satisfy their claims. As the Court stated, "Because any rational creditor would want to protect his investment, such a remedy might induce creditors to engage in a 'race to the courthouse' in cases involving insolvent or near-insolvent debtors, which might prove financially fatal to the struggling debtor." *Grupo*, 527 U.S. at 331. It is questionable whether the Supreme

Court intended for *Grupo* to be read such that any equitable remedy imposing a restriction on a debtor's assets should be denied irrespective of the underlying circumstances.

In this case, the primary issue is not whether Mr. Peerbhai's creditors are trying to impose an injunction on his property through substantive consolidation, thus preventing him from making effective use of his assets. Rather, the issue is whether Mr. Peerbhai so overwhelmingly commingled his personal assets with the assets of AIA and AIG that the only meaningful way to ensure the equitable distribution of assets among the creditors is to consolidate them.

The holding in *Grupo* should not be interpreted to provide a safe haven for debtors who commingle funds, refuse to follow corporate formalities, and deliberately fail to keep adequate records of related party transactions in a bid to conceal their assets from their creditors. Further, *Grupo* does not discuss the remedy of substantive consolidation nor call for its demise. Substantive consolidation, therefore, is still available as a remedy to the courts.

B.

Wells Fargo argues that even if the doctrine of substantive consolidation has not been abrogated by *Grupo*, the doctrine should not be applied retroactively and Wells Fargo's secured interests in Mr. Peerbhai's assets should not be revoked.

Before a court may exercise its equitable *nunc pro tunc* powers, an additional inquiry must be made to see whether retroactivity is necessary to achieve some benefit or avoid harm. *See* American Jurisprudence, *Retroactive Application of Consolidation Order*, 9A Am. Jur. 2d Bankruptcy § 803 (2004). The fact "that a creditor relied on the separate credit of an entity subsequently deemed consolidated in a bankruptcy case bears heavily on the issue of whether to order the consolidation to have a retroactive effect." (Id.). The bankruptcy court decided that retroactive application of substantive consolidation was appropriate in the present case.

As noted in the Standard of Review, the bankruptcy court's findings of law maybe reviewed *de novo* by the district court. The bankruptcy court's determination that Wells Fargo's actions rose to a level high enough to warrant a retroactive application of substantive consolidation is an issue of law the district court may review.

The bankruptcy court, in performing its analysis determined that: First, Wells Fargo did not rely on the separate credit of Mr. Peerbhai, AIA or AIG. (Instrument No. 10, Appendix 1, at 20). Second, substantive consolidation of AIA's and Mr. Peerbhai's assets will result in substantial benefit to all creditors. (Id.). Third, in light of Wells Fargo's knowledge about the commingled assets of Mr. Peerbhai and AIA, Wells Fargo will not be unfairly harmed by substantive consolidation. Fourth, the avoidance of liens granted to

Wells Fargo, will simply return Wells Fargo to its justified position as of the petition date. (Id.).

Based on a *de novo* review of the bankruptcy court's decision, the bankruptcy court took into consideration the essential elements for determining whether substantive consolidation should be applied retroactively. The bankruptcy court's decision is appropriate and should be affirmed.

C.

Wells Fargo's third attack on the bankruptcy court's ruling that Mr. Peerbhai and AIA were alter egos, is that, the bankruptcy court's ruling was improper under Texas Law. (Instrument No. 9, at 12-13). Wells Fargo however believes that had Texas law been applied during the bankruptcy court's determination of the alter ego claim, the outcome would have been different. (Id.). Texas law requires proof of "actual fraud" for a determination that a business owner used the entity as an alter ego. (Id.).

> Texas Business Act, Art. 2.21(A) and 2.21(2) states, in relevant part:
> LIABILITY OF SUBSCRIBERS AND SHAREHOLDERS
> A. A holder of shares, an owner of any beneficial interest in shares, or a subscriber for shares whose subscription has been accepted, or any affiliate thereof or of the corporation, shall be under no obligation to the corporation or to its obligees with respect to:

(2) any contractual obligation of the corporation or any matter relating to or arising from the obligation on the basis that the holder, owner, subscriber, or affiliate is or was the alter ego of the corporation, or on the basis of actual fraud or constructive fraud, a sham to perpetrate a fraud, or other similar theory, unless the obligee demonstrates that the holder, owner, subscriber, or affiliate caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the holder, owner, subscriber, or affiliate.

TEXAS BUSINESS ACT, ART. 2.21(A), 2.2 1(2).

Wells Fargo argues that the bankruptcy court failed to show that Mr. Peerbhai had the actual intent needed to prove actual fraud. (Instrument No. 9, at 12). This is an issue of mixed fact and law.

This Court's review of the records reveals that the bankruptcy court indicated numerous instances and cited many transactions aimed at concealing assets from the creditors of AIA, AIG and Mr. Peerbhai. (Instrument No. 10, Appendix I at 5-13). For instance, the bankruptcy court's findings indicate that twelve months prior to AIA's petition for bankruptcy and even weeks immediately before the petition date, Mr. Peerbhai took measures to transfer assets and transferred assets from AIA. (Instrument No. 10,

Appendix 1 at 5-13). Also, Mr. Peerbhai frequently omitted all relevant information from the books and failed to record substantial payments AIA made directly to Mr. Peerbhai during the 12 months before the petition date. (Id.). Mr. Peerbhai also set up a fictitious entity named Lex, to facilitate the transfer of funds away from his creditors. (Instrument No. 10, Appendix 1 at 12-16). Even weeks before the petition date, Mr. Peerbhai took steps to transfer assets out of AIA. (Id. at 13). The Court may deduce that if there was a time Mr. Peerbhai was more aware of his actions and the repercussions on his creditors claims, it was during the period immediately before bankruptcy. Based on the bankruptcy court's findings, Mr. Peerbhai's actions proving his intent to defraud his creditors were calculated and not merely accidental. The bankruptcy court's decision on the alter ego claim was not erroneous.

IV.

Based on the foregoing, Appellant's motion to dismiss the bankruptcy court's order for substantive consolidation **(Instrument No. 9)** is **DENIED**.

The Clerk shall enter this Order and provide a copy to the Galveston County Clerk for filing in the property record and to all parties.

SIGNED on this the 2nd day of September, 2004, at Houston, Texas.

/s/ Vanessa D. Gilmore
VANESSA D. GILMORE
UNITED STATES DISTRICT JUDGE

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

WELLS FARGO BANK TEXAS, N.A.	§	
	§	
Appellant	§	Civil Action No.H-04-0455
	§	
versus	§	[entered Sept. 6, 2004]
	§	
RONALD J. SOMMERS, et al.	§	
	§	
Appellant	§	

FINAL JUDGMENT

For the reasons stated in the Court's Order, signed on the 2nd day of September, 2004, this action is **DISMISSED.**

THIS IS A FINAL JUDGMENT.

The Clerk shall enter this Order and provide a copy to all parties.

SIGNED this the 2nd day of September, 2004, at Houston, Texas.

/s/ Vanessa D. Gilmore
VANESSA D. GILMORE
UNITES STATES DISTRICT JUDGE

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

IN RE:	§	
	§	CASE NO. 02-31
AMCO INSURANCE	§	265-H5-7
AGENCIES, INC.	§	
DEBTOR(S)	§	[entered Sept. 25,
	§	2003]

FINDINGS OF FACT AND CONCLUSIONS OF LAW

On May 2nd and 23rd, 2003, the Court held an evidentiary hearing on the Application for Substantive Consolidation filed by Ronald J. Sommers, Chapter 7 Trustee for debtor Amco Insurance Agencies, Inc. The application seeks to substantively consolidate debtor's estate with the estate of Rehmat Peerbhai (Peerbhai). The Court has reviewed the application and the responses filed by Peerbhai and Wells Fargo Bank Texas, National Association (Wells Fargo). The Court has further considered the evidence and arguments presented at the hearing on the Application for Substantive Consolidation. The Court finds that the trustee's motion for substantive consolidation should be **GRANTED** and makes the following findings of fact and conclusions of law:

Findings of Fact

Debtor Amco Insurance Agencies, Inc., filed a voluntary petition for relief under Chapter 7 of the Bankruptcy Code in the United States Bankruptcy Court for the Southern District of Texas, Houston Division, on February 4, 2002 (the Petition Date). Ronald J. Sommers was appointed Chapter 7 Trustee (the Trustee) for debtor on February 6, 2002.

The trustee filed the Application for Substantive Consolidation on July 22, 2002, and served a copy on all creditors identified by debtor, including Peerbhai, Amcorp General Agency, Inc., and PC Group Acquisition, II, Inc. Peerbhai and Wells Fargo filed the only objections to the Application for Substantive Consolidation.

At the time of its objections, Wells Fargo's proof of claim against debtor reflected a total claimed indebtedness of $9,970.01, allegedly incurred post-petition. The day of the hearing, debtor and trustee reached an agreement and debtor withdrew his objection. Peerbhai agreed to transfer remaining property held in his daughter's name to the trustee. The trustee agreed to dismiss adversary number _____ and to withdraw all proceedings against Peerbhai and his family.

Background of AMCO Insurance Agencies

Debtor was incorporated on April 21, 1992, under the laws of the State of Texas, with its principal

place of business in Harris County, Texas. Debtor represented to the Texas Department of Insurance that it was a subsidiary of Amco Insurance Group (AIG). Likewise, the schedules filed by debtor and AIG, which Peerbhai signed under penalty of perjury, state that debtor is a 100% wholly-owned subsidiary of AIG. At the same time Peerbhai signed the schedules stating that debtor was a subsidiary of AIG, he executed debtor's initial statement of financial affairs, which state that Peerbhai individually owns 100% of debtor's stock. In its consolidated 2000 tax return, debtor is identified as a wholly-owned subsidiary of AIG. Debtor's corporate books and records, however, show that Peerbhai individually owns 90% of debtor's stock, and his ex-wife, Mumtaz Bana-Peerbhai, owns the remaining 10%. According to debtor's corporate records, this ownership structure has remained constant since the formation of debtor.

According to debtor's corporate books and records, Peerbhai and his ex-wife, Mumtaz Bana-Peerbhai, have been the only directors since debtor's formation. However, debtor's schedules reflect that Peerbhai is the sole officer, director, and shareholder for debtor. Peerbhai has been chief executive officer since 1982. Debtor's chief operating officer was Sher Au Peerbhai (Sher Au), a brother of Rehmat Peerbhai. Debtor's chief financial officer was Saukat Peerbhai (Saukat), another brother of Rehmat Peerbhai. Among other duties, Saukat oversaw debtor's internal accounting department.

According to debtor's corporate books and records, it conducted no annual meeting of the board of directors or shareholders since 1999. While a special meeting of the board of directors was held on June 19, 2000, no other meetings were held between that date and the petition date.

In addition to its own internal accounting department, debtor had at least two outside accounting firms during the years preceding the petition date, Kershaw K. Khumbatta, P.C. and BDO Seidman.

The Business of Debtor

Debtor acted as a managing general agent responsible for the administration of certain automobile insurance programs under a managing general agent's license from the Department of Insurance of the State of Texas. As a general agent, debtor solicited, accepted and received applications for certain classes of automobile coverage, issued and renewed policies, collected and received premiums, and adjusted and paid losses and other claims.

Debtor was able to conduct its business by virtue of certain contracts and agreements with a fronting insurance company and a reinsurance company that ultimately backed the potential losses from the automobile insurance program. Since debtor was not an insurance company in the absence of such agreements and contracts with the fronting insurance company and the reinsurer, debtor could not solicit or issue automobile insurance policies.

The fronting insurance company prior to the petition date was State and County Mutual Insurance Company of Texas (State & County). The reinsurance company for the State & County policies issued by debtor was Gerling Global Reinsurance Corporation of America (Gerling).

Debtor solicited, accepted, and sold the automobile insurance policies across the state of Texas through various retail outlets. The majority of debtor's business involved non-standard auto insurance policies. Non-standard auto insurance policies provide the minimum liability coverage required by Texas law. Such policies are often issued on a monthly basis, and are renewed month by month. Approximately 80% of debtor's non-standard insurance business came from renewals of existing policies, and the balance came from new policies.

Debtor's retail outlets operated under the trade name "Amco Auto Insurance." These retail outlets fell into one of two general categories. The first category was "Company Stores," which were retail outlets owned and operated by debtor and staffed by debtor's employees. The second category of retail outlets was "Franchise Locations," which were owned and operated by independent sub- agents pursuant to "Independent Producer Agreements" between the sub-agents and debtor.

All of debtor's retail outlets were company stores until approximately 1999. That year, Peerbhai began selling company stores to his friends and family,

and later to other investors, to be operated as franchise locations. A franchise who purchased a company store bought the physical assets at the location, any lease for the retail store, the right to use debtor's trademarks, and all renewal business for policies originated by the location when it was a company store, among other assets. As discussed below, Peerbhai individually received all proceeds from the sales of the company stores. Debtor received nothing.

Insurance policy sales from franchise locations were not as lucrative for debtor as sales from company stores. For each non-standard insurance policy sold through a company store, debtor received a commission (a percentage of the premium paid), plus the policy issuance fee. For each non-standard insurance policy sold through a franchise location, debtor received only a small portion of the commission and a reduced part of the policy fees. At some point prior to the petition date, debtor stopped receiving any net commission sold by franchise locations as a result of the performance of the insurance book of business.

Sale of Franchise Locations

According to a franchise offering circular entitled "Prospectus," which debtor prepared in early 1999, debtor owned 134 operating company stores in Texas. No franchise locations were owned by debtor then.

By August 15, 2001, debtor had 133 franchise locations and only 42 company stores in Texas. All of

the franchise locations sold the same non-standard automobile insurance policies as sub-agents of debtor. The vast majority of debtor's company stores were transferred to franchisees between 1999 and the petition date. The transferred company stores represented a major portion of debtor's assets. They also accounted for most of debtor's revenue stream. The majority of these transfers were not documented, or, if they were documented, the documentation is not available.

To the extent that records of some transfers have been uncovered through the diligent efforts of trustee, they show that Peerbhai personally received the consideration paid by purchasers of debtor's company stores. Again, debtor received nothing from the sales and transfers of its assets. Some company stores were sold in exchange for cash paid directly to Peerbhai. Other company stores were sold for a combination of promissory notes and cash paid directly to Peerbhai.

Saukat Peerbhai, debtor's CFO, testified that Peerbhai individually received all payments made for the purchase of debtor's company stores. He also testified that Peerbhai personally handled the accounting and financing related to the sale of debtor's company stores.

In one example, debtor's outside auditors, BDO Seidman, discovered the existence of debtor's sale and transfer of company stores to Shimi Ventures, L.P. Shimi Ventures purchased several company stores, which were then converted to franchise locations. As a

result of this discovery, the auditors obtained the documentation of the transaction and researched the financial records regarding the transaction. While the transaction documents clearly reflected that Shimi Ventures purchased debtor's assets, the financial records reflected that Peerbhai individually received the consideration that Shimi paid for the assets.

Having traced the money received from Shimi Ventures to Peerbhai individually, the auditors compelled debtor to properly record this transfer to Peerbhai in its financial records. Prior to the auditors' action, debtor had made no record of the advance to Peerbhai.

After discovering the Shimi Ventures transfer and debtor's failure to report the payment of sale proceeds to Peerbhai, the auditors asked Saukat Peerbhai if debtor had engaged in any other similar transactions. Saukat failed to disclose the other sales and transfers to Peerbhai. Many other similar sales and transfers have since been discovered by the trustee, but the trustee is still unable to account for the sale and transfer of at least 25 stores. Further, the lack of records prevents the trustee from being able to identify and trace funds from the sale of dozens of others.

No sales of company stores by debtor during the year preceding the petition date have ever been disclosed in debtor's schedules or debtor's initial or amended statements of financial affairs, which Peerbhai signed under penalty of perjury. The Court

finds, however, that such sales did in fact take place during the year preceding the petition date.

The trustee has produced evidence that Peerbhai personally received in excess of one million dollars through his transfer of debtor's company stores. One example is a spreadsheet and related records that track payments on 16 outstanding promissory notes payable to debtor from certain franchisees. The spreadsheet was created and maintained by debtor's CFO arid COO, Saukat and Sher Mi. The spreadsheet reflects the purchase price that 16 franchisees agreed to pay debtor for an unknown number of company stores. It appears that 10 franchisees on the spreadsheet purchased one company store. The remaining six franchisees apparently purchased multiple company stores.

Peerbhai personally received all consideration paid by the 16 franchisees listed on the spreadsheet. Peerbhai claims that he does not know and does not have records to reflect the total amount that he received from these franchisees or what he did with the money that he received.

Another example involves sales to Welson Holdings, a purchaser that is not listed on the spreadsheet. In April 2000, Welson Holdings purchased a company store at 220 East Seminary Drive, Fort Worth, Texas 76115. The consideration paid for the store was a cashier's check for $125,000 payable to Peerbhai individually. Receipt of payment was acknowledged by Ike Mitha in his capacity as general counsel for debtor in a letter written on debtor's

letterhead. Welson Holdings purchased another company store in September 2000 with a $40,000 down payment to Peerbhai, and a promissory note made payable to Peerbhai for $40,000.00. The note itself reflects payment in full to Peerbhai. Again, debtor did not receive any consideration for the company stores purchased by Welson Holdings. These purchases are not noted in debtor's accounting or bank records. Furthermore, these sales were not disclosed to debtor's auditors in response to their direct requests for this information. Nor were these sales reflected on. the spreadsheet discovered by the trustee.

Kershaw Khumbatta was an accountant for both debtor and Peerbhai individually. Khumbatta was never provided any information about the sale of company stores, other than the Shimi Ventures transfer discovered by BDO Seidman, or about the proceeds from those sales. The only information regarding the sale that Khumbatta knew of was set forth in the financial statements audited (and corrected) by BDO Seidman.

Peerbhai's personal financial statements, and all other documents that he has produced to the trustee, fail to reflect any income from the sale of debtor's company stores. His personal financial statements also do not reflect what property or assets Peerbhai purchased with the proceeds from sales of debtor's company stores. There are no available records to show how much money Peerbhai received in exchange for transferring debtor's company stores to franchisees.

Pre-Petition Transfer of Debtor's Remaining Assets

On December 20, 2001, six weeks prior to the petition date, Peerbhai disposed of all remaining company stores and the rest of debtor's assets in a transaction. Consistent with the pattern of conduct described above, Peerbhai transferred debtor's remaining assets and individually received all the proceeds from the transfer.

Specifically, Peerbhai executed an irrevocable option agreement and bill of sale with Onyx Underwriters, Inc. (Onyx) and PC Group Acquisition, II, Inc. (PC Group), whereby Onyx and PC Group purchased all 1,000 outstanding shares of an entity known as Amcorp General Agency, Inc. (Amcorp General) from Peerbhai. "the Onyx/PC Group Transfer." Onyx and PC Group paid Peerbhai $1,501,000 for the shares.

Amcorp General is listed as a subsidiary of AIG on debtor's consolidated financial statements from 1998 to 2000, the last year that such statements were prepared. Peerbhai provided the consolidated financial statements to debtor's lenders, fronting insurers and reinsurers as an accurate depiction of his companies' business structure. Now, however, Peerbhai claims that he personally owned all of Amcorp General's stock prior to the Onyx/PC Group Transfer.

Amcorp General never had an employee, never owned assets, and never had operations of any sort. It did not maintain any financial records. Its franchise tax

records confirm that it had no assets and no revenues in the two years preceding the Onyx/PC Group Transfer.

The irrevocable option agreement identifies 191 franchise locations operating in the state of Texas, and states that Amcorp General is their franchiser. It identifies computers and other office equipment purportedly owned by Amcorp General. The agreement purports to transfer "all applicable licenses, permits, franchises, trademarks, service-marks, registrations, rights-to-do business. . . and all other property, tangible or intangible, associated with the business of the Agencies and/or the Amco organization." The agreement also expressly provides that Amcorp General is not liable "for any of the obligations of AMCO Insurance Agencies, Inc. and/or any of its affiliates." Onyx, PC Group and their affiliates have operated debtor's general agency business since the Onyx/PC Group Transfer occurred.

However, the Court finds Amcorp General did not have the license or the ability to franchise "AMCO" auto insurance retail outlets. Amcorp General did not own any computers or other office equipment. Most importantly, Amcorp General did not own the "licenses, permits, franchises, trademarks, service-marks, registrations, rights-to-do-business.. . and all other property, tangible or intangible, associated with the business of the Agencies and/or the Amco organization." It did not own any assets at the time of the Onyx/PC Group Transfer, much less all the assets used in debtor's business.

Peerbhai admitted that the assets transferred as part of the Onyx/PC Group Transfer belonged to debtor, not to Amcorp General or to him individually. Saukat, debtor's CFO, also admitted that the assets transferred as part of the Onyx/PC Group Transfer belonged to debtor, and not to Amcorp General. Saukat further admitted that Amcorp General had no assets and was an empty shell corporation when the Onyx/PC Group Transfer occurred.

Peerbhai did not differentiate between himself and debtor. Peerbhai failed to keep records or concealed records reflecting the sale of assets belonging to debtor. Peerbhai failed to keep accurate records of his receipt of the proceeds from the sale of debtor's assets or his use of those funds.

Peerbhai testified that he freely took money out of debtor at will and without making a record of such transfers. For example, Peerbhai made the following admission at his deposition, "I always thought [Debtor] belongs to me. I'm the sole shareholder. So I can take out a million dollars or put in a million dollars. It's my company. That's the way I took the company.. . . and when there were funds in the company, I took them out." (Deposition of Rehmat Peerbhai, May 30, 2002; page 250, lines 4-10.) While he freely took funds from debtor and sold its assets for his personal gain, Peerbhai has concealed the trail of the funds to avoid the consequences of having taken them. Due to the lack of documentation, it is presently impossible to determine how much money Peerbhai personally received from selling debtor's assets.

The lack of record keeping is not surprising because Peerbhai and debtor's other chief officers treated debtor's assets and Peerbhai's assets as a common fund. Sher Au, debtor's COO, testified that he made no meaningful distinction between Peerbhai's assets and debtor's assets:

Q. The corporate distinctions [between Peerbhai and debtor] mean nothing to you then really?

A. It does, you know, but he is controlling the whole company.

Q. And what's the company's is his?

A. Yes.

Q. What's his is the company's? Is that right?

A. Yeah.

(Deposition of Sher Mi Perrbhai, September 27, 2002; page 158, line 25 to page 159, line 8.)

As part of the Onyx/PC Group Transfer, Peerbhai caused debtor to enter into an asset purchase agreement with Amco Retail LLC (Amco Retail) to transfer its remaining 33 company stores (the Amco Retail Transfer). The principals of Onyx PC Group (PC Group principals) created Amco Retail for the purpose of purchasing debtor's company stores in December 2001. The Amco Retail Transfer was part of the overall agreement between Peerbhai and Onyx/PC Group.

The Amco Retail Transfer would not have happened without the Onyx/PC Group Transfer.

The transfer of the remaining 33 company stores includes their "machinery, equipment, furniture, supplies, inventory, tools, fixtures leasehold improvements and other tangible personal property," their leases and, most importantly, the Company Stores' Book of Business and Goodwill" to Amco Retail. Amco Retail was supposed to pay $100,000 to debtor in exchange for the transfer. Debtor's bank and accounting records, however, do not show that it received any such payment. It appears that Peerbhai individually received this payment as well.

Four months before the Onyx/PC Group Transfer and the Amco Retail Transfer, the PC Group principals met with Peerbhai to discuss purchasing all of the assets covered by those transfers. They memorialized their discussion in a signed "Business Points" memorandum.

The business points memorandum, and the testimony concerning the structure of the earlier proposed sale, reflect that the PC Group principals and Peerbhai were discussing the transfer of the entire Amco automobile insurance business to PC Group. This earlier proposed transfer would have included the same assets that were ultimately made part of the Onyx/PC Group and Amco Retail transfers. None of the assets were asserted to belong to Amcorp General. The PC Group principals would have paid approximately $12,500,000 for those assets in August

2001. Peerbhai sold these same assets belonging to debtor in December 2001, six weeks before the petition date, for a total of $1,601,000 paid to him individually.

Peerbhai executed the Onyx/PC Group Transfer and the Amco Retail Transfer with the intent to hinder debtor's creditors and to personally profit at debtor's expense. The transfers denuded debtor of almost all of its assets, and the transfers effectively terminated debtor's ability to operate as a going concern. Peerbhai received all the consideration paid for the transfers while debtor received nothing for its assets and business.

Debtor's financial statements dated December 31, 2000, show its fixed assets valued at $1.4 million. According to debtor's schedules, its fixed assets had a value of only $10,000 by the petition date.

The Lex Transfers

In the weeks immediately before the petition date, Peerbhai took certain measures to transfer other assets of debtor. Debtor was the payee under certain outstanding promissory notes made in connection with purchases of company stores. Peerbhai caused debtor to purportedly transfer these promissory notes to a newly formed entity which he owned and controlled, Lex Financial Corporation (Lex). As admitted by Peerbhai and his brothers, the payments under the notes had always been made to Peerbhai personally. Had this purported transfer not been discovered by the trustee, Peerbhai (or his assigns) would have continued

to receive payments under the promissory notes which were given in exchange for the sale of debtor's company stores.

Specifically, at Peerbhai's direction, Lex was formed on January 3, 2002. Ike Mitha, serving as debtor's general counsel, handled the formation. Peerbhai was Lex's sole director, officer, and shareholder. On January 4, 2002, Peerbhai executed a bill of sale on behalf of debtor transferring eleven outstanding promissory notes to Lex (hereinafter, the Lex Transfer). The eleven promissory notes are included in the spreadsheet of sixteen promissory notes referenced above.

As of January 31, 2001, the eleven notes transferred from debtor to Lex remained unpaid. The payment status of the other five promissory notes identified in the spreadsheet is presently unknown and undeterminable. As CEO of debtor, Peerbhai appears to have released at least two of the five unaccounted for promissory notes in exchange for discounted cash payments made to him personally in the month before the petition date. These notes were due to debtor from Alex Trevino and Shafine Sadruddin.

The bill of sale between debtor and Lex, both owned and controlled by Peerbhai, states that Lex paid debtor $100,000 for the eleven promissory notes. Neither Lex nor Peerbhai, however, have actually paid debtor the $100,000 referenced in the bill of sale.

The Lex Transfer was omitted from debtor's schedules and initial and amended statements of financial affairs. Peerbhai did not disclose the Lex Transfer to the trustee or trustee's counsel. Peerbhai attempted to conceal the Lex Transfer from the trustee and debtor's creditors.

Peerbhai further attempted to secret the promissory notes due to debtor by transferring and assigning the promissory notes and the stock of Lex to his brothers, Saukat and Sher Ali. Saukat and Sher Ali then attempted to collect the notes from the payees. Following a scheme originated by Peerbhai, Saukat and Sher Ali attempted to collect on the promissory notes by holding out Lex as an independent company. Of course, it was not. Once Saukat and Sher Ali's involvement in the secreting of the promissory notes was discovered, they rescinded the transaction with Peerbhai.

At the time of the purported transfer of the promissory notes from debtor to Lex and the transfer of Lex to his brothers, Peerbhai was involved in separate litigation with debtor's largest credit, Gerling Global Reinsurance Corporation of America (Gerling), and with Wells Fargo.

Gerling was the primary reinsurer of the AMCO automobile insurance program. Gerling filed its original petition and application for temporary restraining order and temporary injunction on January 3, 2002 in the 95th Judicial District Court of Dallas County, Texas (hereinafter, the Gerling lawsuit). The

Gerling lawsuit named Peerbhai, debtor, Amcorp General, and other Amco entities controlled by Peerbhai as defendants. The Gerling lawsuit alleged, *inter alia*, that debtor and/or its affiliates used premium fluids held in trust for Gerling to pay its operating expenses, converted other funds due to Gerling, overpaid commissions to itself and abandoned its obligations to administer the insurance program that Gerling reinsured.

On January 4, 2002, the same date as the Lex Transfer, the attorney representing Peerbhai, debtor, and the related Amco entities, executed a binding Rule 11 agreement with Gerling's counsel that obligated debtor and the other Amco corporate defendants "not to transfer, dissipate or encumber any of their assets outside the normal course of business until the time of the hearing."

On January 24, 2002, a temporary restraining order was entered in the Gerling lawsuit that ordered debtor and the Amco corporate defendants to "refrain from transferring, encumbering, or dissipating any of their assets outside the normal course of business until the time of the temporary injunction hearing."

The temporary injunction hearing in the Gerling lawsuit was set for February 5, 2002. Debtor filed its bankruptcy petition on February 4, 2002. Accordingly, the Gerling lawsuit was stayed.

Peerbhai, on behalf of debtor, executed the documents that purported to transfer the promissory

notes from debtor to Lex on the same day that debtor's counsel entered a binding Rule 11 agreement stating that debtor would not transfer any assets outside the regular course of business. The Lex Transfer was clearly not within debtor's regular course of business.

On or about January 10, 2002, Wells Fargo filed a lawsuit against MG and Peerbhai (hereinafter, the Wells Fargo lawsuit). According to Wells Fargo's pleading, it filed the lawsuit after learning about the Onyx/PC Group Transfer.

Wells Fargo obtained a temporary restraining order from the 157th Judicial District Court of Harris County, Texas, against Peerbhai and others on January 10, 2002. Under the temporary restraining order, Peerbhai was restrained from transferring or disposing of a material portion of his assets or transferring or dissipating the proceeds of his sale of the stock of Amcorp General. Wells Fargo, Peerbhai, and others submitted an agreed temporary injunction to the state court that was entered on January 23, 2002. Under the temporary injunction, Peerbhai continued to be bound by the same restrictions contained in the prior temporary restraining order.

At the same time that court orders prohibited transfers of property of debtor and Peerbhai, Peerbhai was secretly transferring the debtor's promissory notes to himself and his brothers.

Other Concealed Transfers

In addition to actually concealing (1) the Lex Transfer, (2) the cash payments Peerbhai received from the sale of company stores, and (3) promissory note payments received by Peerbhai, debtor's statements of financial affairs also fail to disclose substantial payments that debtor made directly to Peerbhai during the 12 months before the petition date.

Debtor's statements of financial affairs and schedules also fail to reference the numerous payments that debtor made to third-parties on Peerbhai's behalf. Peerbhai regularly paid his personal expenses with debtor's funds. Many expenses were paid without a written record, and these records cannot be reconstructed. The records that do exist, however, show that Peerbhai made a regular practice of paying his and his family's personal bills from debtor's bank accounts. Written expense records show that debtor paid Peerbhai's home water bill, his home cable bill, his home electric bill, building materials for his home, law maintenance at his home, pool and spa service at his home, repair fees and marina fees for his personal yacht, and cleaning expenses for Peerbhai's Chicago condo. Debtor also paid credit card bills for Peerbhai and his wife that shows purchases at jewelry stores, clothing stores, and Toys R Us, among other non-business purchases. Peerbhai has now conceded this fact, but has neither produced records of this information nor amended debtor's statement of financial affairs or schedules to reflect this information.

Debtor's statements of financial affairs and schedules also fail to record the payments that debtor made for the benefit of other businesses owned by Peerbhai which are unrelated to debtor's business. For example, records show that debtor paid payroll and related expenses for a Day's Inn hotel that Peerbhai owned. Other records show that debtor paid living expenses for the employees of a short-lived restaurant/club that Peerbhai opened in McAllen, Texas called Padrino's, and for a furniture company known as Amco Furniture.

Since 2000, debtor has not made any effort to reconcile its books and records to account for paying Peerbhai's personal and non-debtor business expenses. It would be impossible to reconstruct all the records that show how much money debtor as spent on Peerbhai's personal expenses and the expenses related to his other businesses.

Debtor also paid for other extravagances enjoyed by Peerbhai. For example, debtor paid for a Rolls Royce automobile leased by Peerbhai using the d/b/a of "Amco Insurance," in addition to a Mercedes 500SL, a Chevrolet Suburban, and several other vehicles. The monthly lease payment for the Rolls Royce alone was in excess of $4,000 per month.

Debtor also leased and purchased vehicles for Peerbhai's family.

Peerbhai freely took money from debtor to support an extravagant lifestyle for himself, his wife,

and his children. He also took money from debtor to finance his other business ventures.

Peerbhai's Concealment in the Bankruptcy

Debtor's statements of financial affairs, each of which Peerbhai signed under oath, fail to account for debtor's non-salary payments to Peerbhai, the personal expenses that debtor paid on Peerbhai's behalf, and the expenses that debtor paid on behalf of unrelated companies owned by Peerbhai. They also fail to account for the extravagances that he enjoyed at debtor's expense.

Peerbhai has established a pattern of concealing facts about the financial affairs of debtor and his inappropriate conduct regarding debtor until confronted with documents that prove his sworn statements to be false. Today, he continues to conceal facts regarding the expenses that debtor paid on his behalf and money that he received from debtor or which was rightfully due to debtor.

Peerbhai's Additional Conduct Relating to Debtor

As discussed in detail above, it is clear that money flowed freely between debtor and Peerbhai. Debtor's CFO testified that there was no distinction between what assets belonged to debtor and what assets belonged to Peerbhai. Debtor's records, and the lack thereof, provide additional evidence to support this testimony.

Debtor was a mere instrumentality of Peerbhai. Their financial affairs are hopelessly entangled, and it is impossible to reconstruct where one's assets end and the other's assets begin. Neither Peerbhai nor any records that he or debtor maintained are able to account for how much money he took from debtor in the 12 months before the petition date, or in years past.

Debtor failed to pay state franchise taxes due May 15, 2001. The state Texas duly sent debtor a notice of forfeiture stating that its rights and privileges to operate as a corporation would be revoked for nonpayment of franchise taxes. Debtor did not pay its taxes in response to the notice of forfeiture. Debtor's taxes remained unpaid until October 26, 2001. Peerbhai was an officer and director of debtor during the five-month period between May 15, 2001 and October 26, 2001. See Texas Tax Code § 117.255.

Debtor's records show that Peerbhai used debtor for a fraudulent purpose.

There are no reliable ledgers, financial statements, or accounting information from Peerbhai or debtor that reflect even the financial improprieties already uncovered by the trustee. In addition, Peerbhai and debtor, through Peerbhai, have not cooperated with the trustee's investigation.

Conclusions Of Law

This Court has jurisdiction over this proceeding pursuant to 28 U.S.C. 157 and 1334. This is a core

proceeding as to which the Court may enter final judgment under 28 U.S.C. § 157(b)(2)(A) and (O). Venue of this action is proper in this Court pursuant to 28 U.S.C. § 1408 and 1409(a).

The Court has the jurisdictional authority to substantively consolidate Peerbhai's estate with AIA's estate pursuant to Section 105(a) of the Bankruptcy Code.

All of AIA's creditors will benefit greatly from substantive consolidation with Peerbhai's estate. None of AIA's creditors will be unfairly harmed by the consolidation.

None of Peerbhai's creditors will be unfairly harmed by the consolidation.

Peerbhai made no meaningful distinction between his funds and AIA's funds while AIA was a going concern. Peerbhai and AIA effectively operated as a single financial entity prior to the petition date.

It is impossible to conduct an accurate accounting of the financial affairs of Peerbhai and AIA to segregate their assets because Peerbhai and AIA deliberately failed to keep records and retain documents that would allow such an accounting to be done.

The Fifth Circuit has not provided express guidance on the specific analysis the Court must undertake to determine whether to substantively

consolidate Peerbhai and AIA. The facts of this proceeding, however, support substantive consolidate under each of the various tests recognized by other federal courts.

The financial affairs of AIA and Peerbhai are so entangled that the assets of each cannot be segregated, and consolidation will benefit all creditors. The evidence shows that Peerbhai took at least $3 million from AIA in the two years prior to the petition date and that the total would probably be higher if more records were available.

There is substantial identity between Peerbhai and AIA. Creditors of AIA dealt with Peerbhai and AIA as a single economic unit and did not rely on their separate identity in extending credit.

Substantive consolidation of Peerbhai and AIA is necessary in this case to avoid the substantial harm to creditors that will occur by creating a wall separating the finances of AIA and of Peerbhai that did not exist before the petition date. It will also avoid the harm of AIA's creditors recovering virtually nothing in a bankruptcy that was largely caused by Peerbhai looting the AIA.

Substantive consolidation of Peerbhai and AIA will result in substantial benefit for their creditors. The estate will gain preference and fraudulent transfer actions to set aside transfers to Wells Fargo and potential third parties.

In light of Wells Fargo's knowledge and the circumstances surrounding the execution of the Limited Forbearance Agreement, Wells Fargo is not unfairly harmed by substantive consolidation. To the extent Wells Fargo may have been prejudiced by substantive consolidation, the prejudice is not unfair and the benefits to be gamed by other creditors in this case substantially outweigh any such prejudice. Furthermore, Wells Fargo did not rely on the separate credit of Peerbhai, AIA, or AIG.

The avoidance of the liens granted to Wells Fargo by Peerbhai pursuant to the Limited Forbearance Agreement would simply return Wells Fargo to its position as of the petition date.

The substantial interrelationship of Peerbhai and AIA necessitates the substantive consolidation of their assets and liabilities.

The trustee's substantial efforts to discover the true state of AIA's financial affairs demonstrate that it is impossible to identify or segregate the separate assets and liabilities of Peerbhai and AIA.

Peerbhai and AIA freely commingled assets, treated AIA's assets as Peerbhai's assets, and failed to keep records of the commingling. They failed to keep records that could be used to create records of the commingling. There was a constant, undocumented free flow of funds from AIA to Peerbhai. Peerbhai, his brother the CFO and his brother the COO, treated AIA's assets as if they were Peerbhai's, they did not

keep track of the transfers, and it would be impossible to separate assets of Peerbhai from the assets of AIA.

Peerbhai and AIA did not observe corporate formalities required by Texas law.

Peerbhai's conduct has placed substantial assets of AIA beyond the grasp of AIA's creditors.

Peerbhai treated AIA as an alter ego of himself, taking money out of AIA without observing corporate formalities, usurping corporate assets for his own benefit, and effectively consolidating his own financial being with that of AIA in a way that could not have been ignored by Wells Fargo or any other reasonably diligent party extending credit to Peerbhai. Peerbhai used the AIA's corporate status to commit fraud against his creditors and the AIA's creditors.

The estates of Peerbhai and AIA, including all their respective assets and liabilities, should be substantively consolidated.

The substantive consolidation of Peerbhai and AIA should be effective nunc pro tunc to the petition date because, during all relevant times, Peerbhai and MA operated as one financial entity.

The substantive consolidation of Peerbhai and AIA nunc pro tunc to the petition date follows logically in order to permit creditors of each to be treated in the same manner for purposes of the preference and fraudulent transfer provisions of the Bankruptcy Code.

The benefits of substantive consolidation nunc pro tune to the joint estate's creditors far outweigh any harm to be suffered by Wells Fargo or any other creditor. All avoidance actions that the trustee may gain as a result of nunc pro tunc consolidation are expressly preserved by this order.

Under Texas law, AIA's corporate privileges were revoked upon AIA's failure to pay its state franchise taxes. Pursuant to Texas Tax Code § 171.255, Peerbhai, as an officer and director of AIA, is personally liable for all debts incurred by AIA during the five month period from May 15, 2001 to October 26, 2001.

The trustee's agreement to an order lifting the stay in AIG's bankruptcy case does not operate as any form of estoppel against substantive consolidation or against any avoidance actions that the trustee may file after consolidation. The granting of an order modifying the stay generally does not constitute collateral estoppel, res judicata, or issue preclusion because the procedure for modifying the stay is designed to be a summary proceeding. See Grella v. Salem Five Cent Savings Bank, 42 F.3d 26, 3 1-35 (l' Cir. 1994); Matter of Vitreous Steel Products, 911 F.2d 1223, 1232 (7th Cir. 1990).

Where appropriate, findings of fact set forth herein shall be construed as conclusions of law and conclusions of law set forth herein shall be construed as findings of fact.

Signed this 25 day of Sept, 2003 at Houston, Texas.

/s/ Karen K. Brown
KAREN K. BROWN
UNITED STATES
BANKRUPTCY JUDGE

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

IN RE:	§	
	§	
AMCO INSURANCE	§	CASE NO. 02-31265-H5-7
AGENCIES, INC.,	§	
	§	[entered Nov. 17, 2003]
DEBTOR	§	

ORDER GRANTING SUBSTANTIVE CONSOLIDATION

On May 2 and 23, 2003, a hearing was held on the Application for Substantive Consolidation filed by Ronald J. Sommers, Chapter 7 Trustee for the estate of Amco Insurance Agencies, Inc. (the "Trustee"), seeking to substantively consolidate this bankruptcy estate with the bankruptcy estate of Rehmat Peerbhai, Case No. 02-44814-H5-11, which is also pending in this Court. The Court finds that notice of the Application for Substantive Consolidation was served on all known creditors of both Amco Insurance Agencies, Inc. and Rehmat Peerbhai. For the reasons set forth in the Findings of Fact and Conclusion of Law filed in this case (as those Findings of Fact and Conclusion of Law may be amended), the Court finds good cause to grant the relief requested.

It is hereby ORDERED that this bankruptcy estate is substantively consolidated with the bankruptcy estate of Rehmat Peerbhai, Case No. 02-

44814-H5-11, which consolidation shall be effective *nunc pro tunc* as of February 4, 2002, the date that Amco Insurance Agencies, Inc. filed this bankruptcy case. To the extent necessary, this Order shall preserve any and all avoidance powers of the Trustee for the benefit of the bankruptcy estate, as consolidated. This is a final order.

SIGNED this 17 day of Nov, 2002.

/s/ Karen Brown
HONORABLE KAREN BROWN
UNITED STATES
BANKRUPTCY JUDGE

APPROVED:

/s/ Davis S. Elder

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IN THE UNITED STATES COURT OF APPEALS

FOR THE FIFTH CIRCUIT

No. 04-20841

In The Matter Of: AMCO INSURANCE; REHMAT PEERBHAI

Debtors

WELLS FARGO BANK OF TEXAS N A

Appellant

V.

RONALD J SOMMERS, Trustee; AMCO INSURANCE; REHMAT PEERBHAI

Appellees

Appeal from the United States District Court for the Southern District of Texas, Houston

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May 4, 2006

ON PETITION FOR REHEARING

Before JOLLY, DENNIS, and OWEN, Circuit Judges.

PER CURIAM:

IT IS ORDERED that the petition for rehearing is DENIED.

ENTERED FOR THE COURT:

/s/ E. Grady Jolly
United States Circuit Judge

REHG-2

11 U.S.C.A. § 362(d) (West 2004 & Supp. 2006)

On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest;

(2) with respect to a stay of an act against property under subsection (a) of this section, if--

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization;

(3) with respect to a stay of an act against single asset real estate under subsection (a), by a creditor whose claim is secured by an interest in such real estate, unless, not later than the date that is 90 days after the entry of the order for relief (or such later date as the court may determine for cause by order entered within that 90-day period) or 30 days after the court determines that the debtor is subject to this paragraph, whichever is later—

(A) the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or

(B) the debtor has commenced monthly payments that—

(i) may, in the debtor's sole discretion, notwithstanding section 363(c)(2), be made from rents or other income generated before, on, or after the date of the

commencement of the case by or from the property to each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien); and

(ii) are in an amount equal to interest at the then applicable nondefault contract rate of interest on the value of the creditor's interest in the real estate; or

(4) with respect to a stay of an act against real property under subsection (a), by a creditor whose claim is secured by an interest in such real property, if the court finds that the filing of the petition was part of a scheme to delay, hinder, and defraud creditors that involved either—

(A) transfer of all or part ownership of, or other interest in, such real property without the consent of the secured creditor or court approval; or

(B) multiple bankruptcy filings affecting such real property.

If recorded in compliance with applicable State laws governing notices of interests or liens in real property, an order entered under paragraph (4) shall be binding in any other case under this title purporting to affect such real property filed not later than 2 years after the date of the entry of such order by the court, except that a debtor in a subsequent case under this title may move for relief from such order based upon changed circumstances or for good cause shown, after notice and a hearing. Any Federal, State, or local governmental unit that accepts notices of interests or liens in real property shall accept any certified copy of an order described in this subsection for indexing and recording.

(3)

No. 06-172

FILED
AUG 3 0 2006
OFFICE OF THE CLERK
SUPREME COURT, U.S.

In The

Supreme Court of the United States

RONALD J. SOMMERS, TRUSTEE,

Petitioner,

v.

WELLS FARGO BANK OF TEXAS, N.A.,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

BRIEF IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether Petitioner has presented a compelling reason to grant the Petition, where the Fifth Circuit correctly applied well-established principles governing the use of *nunc pro tunc* orders?

2. Whether Petitioner has presented a compelling reason to grant the Petition, where the Fifth Circuit, contrary to Petitioner's assertion, did not reach the question of whether a "lift-stay" order issued by a bankruptcy judge constitutes a form of issue preclusion?

3. Whether Petitioner has presented a compelling reason to grant the Petition, when the underlying "bankruptcy law remedy" that he sought, namely substantive consolidation, is itself an invalid remedy?

CORPORATE DISCLOSURE STATEMENT PURSUANT TO SUPREME COURT RULE 29.6

Respondent Wells Fargo Bank, N.A. has the following parent company: Wells Fargo & Company (NYSE:**WFC**)

TABLE OF CONTENTS

	Page
STATEMENT	1
SUMMARY OF ARGUMENT	2
ARGUMENT	3
1. The opinion below correctly applies *nunc pro tunc* principles	3
2. The "issue preclusion" conflict is illusory	7
3. The real problem illustrated by the litigation below is the unprincipled (and invalid) remedy of substantive consolidation	8
CONCLUSION	23

TABLE OF AUTHORITIES

Page

CASES

In Re American Homepatient, Inc., 298 B.R. 152 (Bankr. M.D. Tenn., 2003) 17

Arbaugh v. Y&H Corp. d/b/a The Moonlight Cafe, 546 U.S. ___, 126 S. Ct. 1235 (2006) 19

Atherton v. FDIC, 519 U.S. 213 (1997) 21

In re Augie/Restivo Baking Co., Ltd., 860 F.2d 515 (2nd Cir. 1988) 10

Butner v. United States, 440 U.S. 48 (1979) 15, 21

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In re Commercial Envelope Manufacturing Co., 3 Bankr. Ct. Dec. (CRR) 647, 14 Collier Bankr. Cas. (MB) 191 (S.D.N.Y. 1977) 10

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TABLE OF AUTHORITIES – Continued

Page

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In re Little Creek Development Co., 779 F.2d 1068 (5th Cir. 1986) 7

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Norfolk Shipbuilding & Drydock Corp. v. Garris, Administratrix, 532 U.S. 811 (2001) 16

Norwest Bank W[illegible]thington v. Ahlers, 485 U.S. 197 (1988) 6

O'Melveny & Meyers v. FDIC, 512 U.S. 79 (1994) 21

Pa. Bureau of Correctional v. U.S. Marshall Serv., 474 U.S. 34 (1985) 22

Raleigh v. Illinois Department of Revenue, 530 U.S. 15 (2000) 15

TABLE OF AUTHORITIES – Continued

Page

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In re Triangle Chemicals, Inc., 697 F.2d 1280 (5th Cir. 1983) 3

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United States v. Bestfoods, 524 U.S. 51 (1998) 9, 21

United States v. Kimbell Foods, Inc., 440 U.S. 715 (1979) 20, 21

Walker v. Cadle Co., 51 F.3d 562 (5th Cir. 1995) 20

STATUTES

11 U.S.C. § 101 *et seq.* 5

11 U.S.C. § 105 22

11 U.S.C. § 549 5

TABLE OF AUTHORITIES – Continued

Page

OTHER AUTHORITIES

Douglas G. Baird, *Substantive Consolidation Today*, Vol. XLVII, Boston College Law Review 1 (December 2005) 19

Simon Bowmer, *To Pierce or Not to Pierce the Corporate Veil: Why Substantive Consolidation is Not an Issue under English Law;* 15 Journal of International Banking Law 193 (August 2000) 16

Committee on Bankruptcy and Corporate Reorganization of The Association of the Bar of the City of New York, *Structured Financing Techniques*, 50 Bus. Law 527 (1995) 14

Steve H. Nickles & David G. Epstein, *Another Way of Thinking About Section 105(a) and Other Sources of Supplemental Law Under the Bankruptcy Code*, 3 Chapman Law Review 7-20 (Spring 2000) 22

Richard A. Posner, *The Rights of Creditors of Affiliated Corporations,* 43 U. Chi. L. Rev. 499 (1976) 13

Sabin Willett, *The Doctrine of Robin Hood, A Note on "Substantive Consolidation,"* 4 DePaul Business & Commercial Law Journal 87 (Fall 2005) 19

STATEMENT

Respondent generally adopts as its statement the court of appeals' recitation of the background facts. *See* Petitioner's Appendix ("App.") at 2-7. Pursuant to the obligations imposed by Supreme Court Rule 15(2), Respondent perceives several material misstatements of law and fact in the Petition for a Writ of Certiorari (the "Petition").

First, the Petition asserts that the court of appeals established a rule that an order lifting the stay has an "estoppel" or "issue preclusive" effect. As will be argued herein, the court of appeals actually held that *nunc pro tunc* "substantive consolidation"[1] relief was unavailable under the facts presented.

Second, with respect to factual matters, the Respondent denies that it has "gamed the system." No lower court made such a finding. Respondent denies the Petitioner's suggestion that Respondent engaged in misconduct in collecting the debts owed in these bankruptcy cases. The bankruptcy judge made no fact finding that Respondent misled the Petitioner or any creditor. To be sure, the bankruptcy judge made a vague reference to Respondent's supposed "knowledge" as a basis to hold that the Respondent was not "unfairly harmed" by substantive consolidation. App. at 59. However, the bankruptcy judge never made a finding of what exactly the Respondent knew, and why such knowledge justified the bankruptcy court's stripping the Respondent of its liens.

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[1] The term "substantive consolidation" will be defined in argument 3 herein.

SUMMARY OF ARGUMENT

Petitioner has presented no "compelling reasons" for his Petition to be granted. *See* Sup. Ct. R. 10. Petitioner has failed to demonstrate that the Fifth Circuit's March 31, 2006 Opinion ("Opinion") is in conflict with a decision of this Court or another court of appeals.

Petitioner contends that the courts of appeals are split on whether an order modifying the automatic stay serves to preclude remedies under bankruptcy law. Petition at 11. More directly, Petitioner contends that the Fifth Circuit's Opinion exemplifies a holding on issue preclusion. This argument is belied by the text of the Fifth Circuit's Opinion. Notably the Opinion makes no reference to collateral estoppel, res judicata or issue preclusion.

Instead the Fifth Circuit's Opinion exemplifies a correct application of *nunc pro tunc* principles in bankruptcy cases. In its application of these equitable, factually driven principles, the Fifth Circuit weighed the actions taken by Respondent in reliance upon a lift-stay order. Based upon Respondent's reliance the court of appeals concluded that *nunc pro tunc* relief was unavailable to undo the actions taken by Respondent.

Petitioner further argues that the Fifth Circuit has made an erroneous application of issue preclusion principles that bars "bankruptcy law remedies" generally. However the remedy sought by Petitioner below, namely "substantive consolidation," is not a valid bankruptcy law remedy. In weighing whether to grant certiorari, the Court should consider whether Petitioner's underlying assumption as to the validity of substantive consolidation is correct.

ARGUMENT

1. The Opinion below correctly applies *nunc pro tunc* principles.

There is no conflict among the circuits on the issue actually decided below. The issue decided was whether "the bankruptcy court erred in issuing the order to consolidate *nunc pro tunc*." App. at 7.

The court of appeals' stated rationale for reversal falls squarely within well established principles governing *nunc pro tunc* orders. Black's Law Dictionary defines *nunc pro tunc* as relief that has a retroactive legal effect. Black's Law Dictionary (7th ed. 1999). In *Mitchell v. Overman*, 103 U.S. 62 (1880), the Court concluded that *nunc pro tunc* orders are allowed in limited circumstances, such as where the delay in entry of an order was caused by the court's convenience or some cause not attributable to the laches of the parties. In that regard the Court held that lower courts should look at the particular circumstances of the case and weigh the equities of the relief.

Nunc pro tunc relief in bankruptcy cases is a separate and distinct principle from issue preclusion. For example, in *In re Triangle Chemicals, Inc.*, 697 F.2d 1280, 1288-89 (5th Cir. 1983), the court of appeals held that the bankruptcy court had discretion to appoint an attorney to serve as counsel on a *nunc pro tunc* basis. However, the court of appeals also observed that it allows *nunc pro tunc* orders only in "rare or exceptional circumstances." *Id.* 1289. Because counsel had "performed valuable services for the debtor's estate that have increased the common funds available for distribution to the creditors" the court of appeals recognized a limited discretion should be available

for *nunc pro tunc* relief as necessary to avoid a windfall for creditors.

In the case at hand, the narrow issue decided by the court of appeals is whether a bankruptcy court may issue a substantive consolidation order, on a *nunc pro tunc* basis, when the effect of granting retroactive relief is to nullify actions taken by a creditor in reliance on a prior lift-stay order. Respondent relied upon the lift-stay order in prosecuting a collection action against the debtor's stockholder. The court of appeals correctly applied *nunc pro tunc* principles in concluding that the lower court erred in granting relief. In substance the court of appeals has held that a bankruptcy trustee in the bankruptcy case of a later-in-time filed debtor may not obtain *nunc pro tunc* equitable relief that back-dates the later-filed debtor's bankruptcy petition date, if (i) a creditor of the later-filed debtor has acted in reliance upon an order of the bankruptcy court issued in a case concerning an affiliate of such later-filed debtor, and (ii) *nunc pro tunc* relief in the later-filed debtor's case would prejudice such creditor.

In addition to correctly applying general *nunc pro tunc* principles, the Fifth Circuit's holding is faithful to the text of the Bankruptcy Code. This is shown by reference to four key dates:

February 4, 2002	A Texas corporation files for bankruptcy. App. at 3.
April 10, 2002	Such corporation's stockholder (a natural person) and Respondent enter into a forbearance agreement, under which certain of the stockholder's assets are pledged to Respondent. App. at 3.

July 11, 2002	The Petitioner as trustee for the corporation files an application to substantively consolidate the stockholder with the corporation. App. at 3.
December 11, 2002	The stockholder files for bankruptcy. App. at 4.

By granting a *nunc pro tunc* consolidation order, the bankruptcy judge effectively back-dated the December 11 filed case to a February 4 dated case. This prejudiced the Respondent because Section 549(a) of the Bankruptcy Code[2] permits the bankruptcy trustee to avoid all transfers made after the "commencement of the case." Normally this bright-line rule makes sense. Anyone dealing with assets of a person in bankruptcy is placed on notice that bankruptcy court approval is required before the transaction is binding. But if a bankruptcy judge has power to consolidate a debtor and non-debtor affiliate (who later files a separate bankruptcy petition) on a *nunc pro tunc* basis, third parties will be reluctant to enter into transactions with the non-bankrupt affiliates, as these transactions become subject to Section 549 avoidance. That is what happened below. The Respondent reached an agreement with a natural person eight months before he filed for bankruptcy. Liens granted by this person prior to the "commencement of [his] case" are not avoidable under the plain meaning of Section 549 of the Bankruptcy Code.

The bankruptcy judge's order which "back-dated" the "commencement of the case" under a *nunc pro tunc* rule, blurs the bright-line rule codified in Section 549(a), creating

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[2] 11 U.S.C. § 101 et seq.

a result that is at odds with the Bankruptcy Code. This result cannot be justified using general equity powers. As this Court explained in *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988), whatever equitable powers remain in bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code.

The Fifth Circuit's limitation on *nunc pro tunc* substantive consolidation relief in this case promotes out-of-court settlements between creditors and borrowers who happen to be affiliated with an entity in bankruptcy. The District of Columbia Circuit recognized this important policy consideration when it imposed similar restrictions on the use of *nunc pro tunc* substantive consolidation relief in *Drabkin v. Midland-Ross Co.* (*In re Auto-Train Corp.*) 810 F.2d 270, 276 (D.C. Cir. 1987):

> Were bankruptcy courts permitted to consolidate entities *nunc pro tunc* without regard to transferees' reliance on an entity's apparent separateness, a sign of weakness in any member of a family of corporations would lead creditors to descend on each member, strong or weak, to claim their pound of flesh. Such a rule would also sharpen people's natural reluctance to extend credit to any affiliate of a financially troubled corporation. This in turn would imperil the ability of financially sound affiliates to continue operations and help the more troubled ones out of their predicament.

In sum, the court of appeals' disposition of the appeal below is based solely upon *nunc pro tunc* principles. The Fifth Circuit's Opinion is not in conflict with any precedent of this Court, nor the holdings of other circuits.

2. The "issue preclusion" conflict is illusory.

Petitioner's contention, that the Fifth Circuit's Opinion conflicts with other circuits by holding that lift-stay orders have a preclusive effect, is belied by inspection of the text of the Opinion, which does not contain any of the following terms of art: (i) *res judicata*, (ii) collateral estoppel, (iii) claim preclusion, or (iv) issue preclusion. Yet Petitioner argues that the Fifth Circuit is in conflict with the First, Seventh, Ninth and Eleventh Circuits with respect to principles of issue preclusion in bankruptcy.[3]

In truth the Fifth Circuit is in agreement with the First, Seventh, Ninth and Eleventh Circuits, having held in other cases that lift-stay orders are summary proceedings with little preclusive effect. For example, in *In re Little Creek Dev. Co.*, 779 F.2d 1068, 1074 (5th Cir. 1986), the Fifth Circuit observed that counterclaims may not be asserted in automatic stay litigation because of the expedited treatment required of stay motions. Furthermore, in *D-1 Enters., Inc. v. Commercial State Bank*, 864 F.2d 36, 40 (5th Cir. 1989), the Fifth Circuit held that orders issued in "contested matters" (including lift-stay orders) do not bar other claims under the *res judicata* doctrine.

In sum, Petitioner requests this Court to review an issue that was not decided below. But even if this issue had been reached, there is no material conflict among the circuits on this issue. Accordingly, the Petition does not meet this Court's criteria for certiorari review.

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[3] None of the cases cited by Petitioner concern *nunc pro tunc* orders, the issue actually decided below.

3. The real problem illustrated by the litigation below is the unprincipled (and invalid) remedy of substantive consolidation.

The "Questions Presented" found on page (i) of the Petition make clever use of the phrase "bankruptcy law remedies." This is because the "bankruptcy law remedy" at issue here, namely substantive consolidation, will be shown to be invalid upon application of this Court's jurisprudence. Respondent will show that assuming *arguendo* the court of appeals erred in an application of issue preclusion principles, such error is harmless because the underlying remedy of substantive consolidation is itself invalid.

This litigation arose out of Petitioner's selection of a uncharted "nuclear weapon" called substantive consolidation. Substantive consolidation is a federal judge made remedy that results in a merger of separate entities so that their assets and liabilities may be aggregated. The federal courts that have authorized this relief explain that the nature and effect of substantive consolidation closely resembles a statutory corporate merger, except that the rights of creditors (instead of stockholders) are affected. Substantive consolidation usually results in the pooling the assets of, and claims against, the two entities; satisfying liabilities from the resulting common fund; eliminating inter-company claims; and combining the creditors of the two companies. *See Union Savings Bank v. Augie/Restivo Baking Co., Ltd.* (*In re Augie/Restivo Baking Co.*), 860 F.2d 515, 518 (2nd Cir. 1988)

The substantive consolidation remedy is "uncharted" in the sense that Congress has not provided statutory authority for the remedy. This Court has never adopted the doctrine in a *stare decisis* sense, nor has it provided

standards for its usage. Indeed this Court has repeatedly held it is the province of Congress to provide a federal law remedy to enforce a substantive right in federal court. *See, e.g., Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979). Substantive consolidation is "nuclear" in the sense that contrary to bedrock corporate law principles, it results in a corporate shareholder's assets becoming available to the corporation's creditors.[4]

Corporate law (including corporate mergers) is based for the most part on statutes enacted by state legislators. How then have many of our federal courts authorized the remedy of substantive consolidation of corporations without statutory authority? As shown below, by "federal-izing" state alter-ego law.

A. *Its short history*. Substantive consolidation emerged as a federal law concept in the 1960's and 70's in a series of holdings issued by the Second Circuit. Starting with *Soviero v. Franklin Nat'l Bank of Long Island*, 328 F.2d 446, 448 (2nd Cir. 1964), the Second Circuit rejected a creditor's contention that corporate veils can be pierced only in cases of fraud (as required by state law). Then in *Chemical Bank v. Kheel*, 369 F.2d 845, 847 (2nd Cir. 1966) the Second Circuit relied not solely on state law alter-ego factors, but also on the sheer cost of sorting out the various rights and obligations. The contours of this new federal judge-made law of consolidation was further developed by the Second Circuit in *Flora Mir Candy Corp.*

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[4] *United States v. Bestfoods*, 524 U.S. 51 (1998) "It is a general principle of corporate law deeply 'ingrained in our economic and legal systems' that a parent corporation (so-called because of control through ownership of another corporation's stock) is not liable for the acts of its subsidiaries."

v. R. S. Dickson & Co. (*In re Flora Mir Candy Corp.*), 432 F.2d 1060, 1062-63 (2nd Cir. 1970). Here a "creditor reliance" inquiry (again, having no basis in state alter ego law) became determinative. Finally, in *James Talcott, Inc. v. Wharton* (*In re Continental Vending Mach. Corp.*), 517 F.2d 997, 1000-02 (2nd Cir. 1975), *cert. denied*, 424 U.S. 913 (1976) the Second Circuit concluded its development of consolidation principles under the former Bankruptcy Act, allowing a hybrid form of consolidation. The modern term "substantive consolidation" appears in a reported decision for the first time in 1977. In *In re Commercial Envelope Manufacturing Co.*, a bankruptcy court observes: "[s]ubstantive consolidation, as will be seen, is now part of the warp and woof of the fabric of the bankruptcy process involving related debtors, though to be used sparingly."[5]

In the 1980's, the Second Circuit collapsed its prior holdings into a two-pronged balancing test. Specifically in *In re Augie/Restivo Baking Co., Ltd.*, 860 F.2d 515, 518-19 (2nd Cir. 1988), the court of appeals held that a bankruptcy court may grant substantive consolidation upon answering either of the following questions in the affirmative: (i) whether creditors dealt with the entities as a single economic unit and "did not rely on their separate identity in extending credit,". . . .; or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors."

Other circuits followed suit announcing their own standards, such as the balancing test for substantive

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[5] 3 Bankr. Ct. Dec. (CRR) 647, 648, 14 Collier Bankr. Cas. (MB) 191, 192 (S.D.N.Y. 1977).

consolidation found in *Eastgroup Properties v. Southern Motel Ass'n, Ltd.*, 935 F.2d 245, 249 (11th Cir. 1991):

> The proponent of substantive consolidation must show that (1) there is substantial identity between the entities to be consolidated; and (2) consolidation is necessary to avoid some harm or to realize some benefit. When this showing is made, a presumption arises that creditors have not relied solely on the credit of one of the entities involved. Once the proponent has made this prima facie case for consolidation, the burden shifts to an objecting creditor to show that (a) it has relied on the separate credit of one of the entities to be consolidated; and (b) it will be prejudiced by substantive consolidation.

Those courts adopting substantive consolidation have acknowledged that the doctrine lacks a statutory foundation, and further that it represents a significant departure from state law. *See FDIC v. Colonial Realty Co.*, 966 F.2d 57, 59-61 (2nd Cir. 1992), in which the Second Circuit summarized the difference between state "alter ego" law and federal "substantive consolidation" principles as follows: "[t]he focus of piercing the corporate veil is the limited liability afforded to a corporation;" whereas, the focus of substantive consolidation is "the equitable treatment of all creditors." However use of this federal common law methodology aimed at achieving "equitable treatment" for all creditors has created difficult interpretive problems for parties and courts.

B. *Interpretive Problems.* In practice the federal judge-made "balancing tests" have not provided much predictability. While these balancing tests give lip service to the proposition that the consolidation remedy is unavailable if a creditor demonstrates prejudice, the case at

hand demonstrates how illusory this creditor protection is in practice. The bankruptcy court below ignored the Respondent's "lien-striping" prejudice, concluding instead that substantive consolidation is permitted so long as the objecting creditor is "not unfairly harmed." App. at 59. However, reliance upon a bankruptcy judge's individualized notion of "fairness" is anathema to the rule of law. Substantive consolidation, lacking any real limitations on its applicability, lends itself to such judicial mischief.

Under the current standards in vogue among the circuits, one cannot answer, with any certainty, basic questions such as: (i) whether a bankruptcy court may substantively consolidate a non-debtor entity with a debtor in bankruptcy, (ii) whether the entities to be consolidated must have a 100% direct ownership affiliation (i.e. no minority shareholders), and (iii) whether retroactive (*nunc pro tunc*) consolidation is permitted?

Not surprisingly the courts that have adopted substantive consolidation disagree on such issues, as well as the frequency with which consolidation should be used.[6] Some courts of appeals make reference to a "liberal trend" favoring increased use of substantive consolidation, while others disavow such trend and instead have announced standards which severely restrict the use of consolidation. Compare the Eleventh Circuit's *Eastgroup Property* opinion, 935 F.2d at 248-49, with the Third Circuit's opinion in *Credit Suisse First Boston v. Owens Corning*

[6] While a full discussion of the many varieties of substantive consolidation is unnecessary for the purpose of this Brief, Respondent notes that three of our courts of appeals (the Fifth, Sixth and Seventh Circuits) have not yet adopted any form of the doctrine in a *stare decisis* sense.

("*Owens Corning*"), 419 F.3d 195, 209, footnote 15 (3rd Cir. 2005), *cert. denied*, 126 S.Ct. 1910 (May 1, 2006). All of these conflicting observations leave parties and lower courts guessing what standard for consolidation will apply to a given set of facts.

Substantive consolidation will always harm certain creditor groups as priorities among creditors of separate entities are altered. "Because the entities sought to be consolidated frequently will have different debt-to-asset ratios, substantive consolidation invariably redistributes wealth among the entities' creditors." *E.g.*, *Eastgroup Properties v. Southern Motel Ass'n, Ltd.*, 935 F.2d 245 (11th Cir. 1991) (quoting *Drabkin v. Midland-Ross Co.* (*In re Auto-Train Corp.*), 810 F.2d 270, 276 (D.C. Cir. 1987)). While some courts cite "efficiency" as the bankruptcy policy objective achieved by the doctrine, other voices question whether the supposed efficiency outweighs the costs of this rule. *See*, *e.g.*, Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 518 (1976) Posner argues that "[t]o the extent that one of the bankrupts has greater assets relative to the claims of its own creditors than the other has, consolidation harms those creditors and helps the affiliate's creditors. The prospect of consolidation means that a creditor can make a total evaluation of the risks that he faces only by considering the risk of insolvency of the borrower's affiliates as well as the risk of insolvency of the borrower itself." With the passage of time, Posner's prediction that substantive consolidation would increase the cost of credit has become manifest. For example in the current marketplace for loans, borrowers frequently encounter the significant expense of law firm legal opinions designed to reduce the risk of consolidation, and which by "custom and

practice this type of counsel opinion is requested and given for newly formed entities whose 'special purpose' is to obtain structured financing (i.e., where 'a defined group of assets . . . [are] structurally isolated, and thus serve as the basis of financing." Committee on Bankruptcy and Corporate Reorganization of The Association of the Bar of the City of New York, *Structured Financing Techniques*, 50 Bus. Law 527, 529 (1995).

C. *The Constitutional Problem.* While parties and courts have spent countless hours fussing over the rules of decision, surprisingly little attention has been given to whether there is a judicial power to grant substantive consolidation relief. The authority for federal judge-made substantive law is problematic. Based upon separation of power concerns, this Court has held that federal courts lack authority to promulgate generalized standards which have the effect of adjusting priorities in bankruptcy cases. *See U.S. v. Noland*, 517 U.S. 535 (1996), and *U.S. v. Reorganized CF&I Fabricators of Utah, Inc.*, 518 U.S. 213 (1996). Yet the federal judge made doctrine of substantive consolidation, by merging assets and liabilities of a parent and subsidiary, modifies the state-law based priority that creditors of the subsidiary normally have to the assets of the subsidiary. In *Noland* and *CF&I Fabricators*, this Court explained that promulgation of generalized rules which categorically modify priorities in bankruptcy is a legislative function, not a judicial function. Under this reasoning, even though legislatures have not established standards for substantive consolidation, the courts are not by implication authorized to perform a legislative function such as announcing general standards for substantive consolidation.

Consistent with such separation of powers concerns, this Court has directed the federal courts to look to state law for the sources of substantive law, absent a federal statute authorizing the relief requested. *See Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938). Eventually this principle was applied in the bankruptcy context as well. *See Butner v. United States*, 440 U.S. 48, 55 (1979) (property interests are created and defined by state law, unless some federal statute or federal interest requires a different result). *See also Raleigh v. Illinois Department of Revenue*, 530 U.S. 15 (2000) (holding that the validity of a claim in bankruptcy is generally a function of underlying state law).

State law does not recognize "substantive consolidation" *per se*. Nevertheless, the perception persists that federal courts have the power to both grant and promulgate standards for substantive consolidation using federal common law and equity principles. Just last year the Third Circuit introduced its discussion of substantive consolidation as follows: "[s]ubstantive consolidation, a construct of federal common law, emanates from equity." *Owens Corning*, 419 F.3d at 205. Such courts have misrelied upon equity, federal common law, and this Court's precedents.

(i) *Misreliance upon equity.* Reliance upon federal equitable principles as authority for substantive consolidation is unwarranted under this Court's decisions. In 1999 the Court explicitly restricted the use of federal equity powers to those equitable remedies that existed in the English Court of Chancery in 1789. *See Grupo Mexicano de Desarrollo, S.A. v. Alliance Bank Fund, Inc.*, 527 U.S. 308 (1999) (reversing pre-judgment injunctive relief as unavailable in 1789). *See also Great West Life and Annuity Ins. Co. v. Knudson*, 534 U.S. 204 (2002) (holding this 1789

equity cutoff principle applies to a request for equitable relief under ERISA, which arguably like the Bankruptcy Code is a "comprehensive and reticulated statute"). *See also Norfolk Shipbuilding & Drydock Corp. v. Garris, Administratrix*, 532 U.S. 811, 820 (2001), in which the Court observes with respect to its prior holding in *Grupo Mexicano* that the "equitable lawmaking power of bankruptcy courts [is] limited by statute."

The remedy of substantive consolidation did not exist in the English Court of Chancery in 1789, and does not exist in England today. Contemporary English lawyers have observed that English courts have not followed the lead of the American courts in developing a substantive consolidation doctrine. *See* Simon Bowmer, *To Pierce or Not to Pierce the Corporate Veil: Why Substantive Consolidation is Not an Issue under English Law*; 15 Journal of International Banking Law 193 (Issue 8, August, 2000).

Application of the *Grupo Mexicano* principle to bankruptcy courts, being units of the federal district courts, eliminates substantive consolidation as a viable federal judge made equitable remedy. The court of appeals below seemed to recognize this probable outcome. The Fifth Circuit's Opinion makes passing reference to *Grupo Mexicano*, but the court of appeals decided to defer ruling on the issue until another day choosing instead to make a narrower *nunc pro tunc* holding. App. at pages 6, 7 and 13.

Respondent is duty-bound to disclose that several courts have concluded that the *Grupo Mexicano* decision has had no impact on substantive consolidation, including

the Third Circuit[7] in *Owens Corning*, 419 F.3d at 206, *In Re American Homepatient, Inc.*, 298 B.R. 152 (Bankr. M.D. Tenn., 2003), and *In re Stone & Webster, Inc.* 286 B.R. 532 (Bankr. D. Del. 2002). These courts rely upon this Court's decision in *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215 (1941) ("*Sampsell*") as *stare decisis* authority for substantive consolidation. But did this Court really invent substantive consolidation back in 1941?

(ii) *Misreliance upon Sampsell.* Careful reading of *Sampsell* reveals that instead of authorizing substantive consolidation, the Court only ruled on whether the court of appeals had correctly granted a priority claim in bankruptcy. A similar bankruptcy priority dispute was decided by the Court last term in *Howard Delivery Service, Inc. v. Zurich American Insurance Co.*, 547 U.S. ___, 126 S.Ct. 2105 (2006). In *Howard Delivery* this Court cites *Sampsell* for the proposition that "[t]he theme of the Bankruptcy Act is 'equality of distribution', . . . and if one claimant is to be preferred over others, the purpose should be clear from the statute." 126 S.Ct. at 2116.

In *Sampsell* a bankruptcy trustee had asserted that an individual debtor's transfer of his property to an affiliate corporation was not in good faith, and was made for the purpose of placing it beyond the reach of the individual's creditors. Based upon these facts, the bankruptcy referee granted an order directing the affiliate to show cause why its assets should not be marshaled for the

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[7] Remarkably, the Third Circuit concludes this Court approved substantive consolidation six decades ago. Then the Third Circuit qualifies its assertion stating this Court approved it "at least indirectly and perhaps inadvertently." *See Owens Corning*, 419 F.3d at 206. This is hardly a ringing endorsement.

benefit of the creditors of the individual. After a hearing, the bankruptcy referee granted the trustee relief against the affiliate corporation, and the trustee took possession of its assets.

In a subsequent "claim objection" type proceeding in the individual debtor's case, a creditor of the corporation, who was not a party to the earlier proceeding, filed a claim asserting priority to the corporate assets. The Court noted that the initial bankruptcy court order had not adjudicated the priority of creditors of the corporation vis-a-vis the creditors of the debtor stockholder. While normally creditors of the corporation would be entitled to satisfy their claims out of corporate assets prior to any participation by the creditors of the individual stockholder, here the corporate creditor was found to have had knowledge regarding the fraudulent transfer of assets from the stockholder to the corporation. Furthermore, the corporate creditor was neither a "lien creditor nor an innocent grantee for value." *Id.* at 220. Concluding that the bankruptcy referee had subject matter jurisdiction to direct the turnover of the affiliate's assets, the Court held that the creditor could not collaterally attack the prior order and held that the corporate creditor should have no priority claim under the facts presented.

Clearly the Court in *Sampsell* did not reach the issue of whether an order of "substantive consolidation" (as that term is now used) between a debtor and an affiliate was a proper exercise of judicial power. Rather *Sampsell's* holding exemplifies an application of the well-established prohibition against "collateral attack" of judgments. Generally, the policy against collateral attack precludes a subsequent challenge to an otherwise final order so long as the court that issued the order had subject matter

jurisdiction to issue that general kind of order, and regardless of whether the specific relief granted was correct from a substantive point of view. *Sampsell* was decided under the former Bankruptcy Act of 1898, when the summary/plenary jurisdiction dichotomy resulted in uncertainty as to a bankruptcy referee's subject matter jurisdiction. *Sampsell's* true holding is that in the context of an individual and his family owned corporation, such corporate entity could not insist on a plenary suit. *Id.* at 218. Because this Court concluded the bankruptcy referee had subject matter jurisdiction, the referee's prior order directing the corporation to turnover assets could not be collaterally attacked by the corporate creditor.[8]

How is it that several lower courts have misinterpreted *Sampsell* as this Court's *stare decisis* endorsement of substantive consolidation? The Court recently signaled the probable cause of the confusion. Justice Ginsburg, writing on behalf of the Court in *Arbaugh v. Y&H Corp. d/b/a The Moonlight Café,* 546 U.S. ___, 126 S.Ct. 1235 (2006), noted that: "[j]urisdiction, this Court has observed, is a word of many, too many, meanings. This Court, no less

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[8] Subsequent to the publication last year of the *Owen's Corning* opinion, several commentators have published articles openly skeptical of the Third Circuit's conclusion that *Sampsell* is *stare decisis* on the issue of the power of the bankruptcy court to consolidation. Professor Douglas G. Baird of the University of Chicago Law School writes that "the U.S. Supreme Court has never formally embraced the concept" and that while Justice Douglas came "closest to doing so" in the *Sampsell* case, *Sampsell* merely involved a recovery of assets that had been fraudulently conveyed. *See* Douglas G. Baird, *Substantive Consolidation Today*, Vol. XLVII Boston College Law Review 1, 15 (December 2005). Further arguments regarding the limited holding of the *Sampsell* case are found in Sabin Willett, *The Doctrine of Robin Hood, A Note on "Substantive Consolidation,"* 4 DePaul Business & Commercial Law Journal 87 (Fall 2005).

than other courts, has sometimes been profligate in its use of the term," and that with respect to "the subject-matter jurisdiction/ingredient-of-claim-for-relief dichotomy, this Court and others have been less than meticulous." (internal quotation marks omitted). 126 S.Ct. at 1242. So while *Sampsell* concerned subject matter jurisdiction – whether the bankruptcy referee had summary jurisdiction over a corporation owned by the bankrupt's family – Respondent suggests that *Sampsell's* use of the word "jurisdiction" has led some lower courts erroneously to conclude that *Sampsell* created a new federal cause of action now known as substantive consolidation.

(iii) *Misreliance upon federal common law.* Finally the Third Circuit cites "federal common law" as yet another basis for federal courts to invent substantive consolidation. *Owens Corning* at 205. However our circuits are in conflict over the notion of a federal common law of bankruptcy. In *Walker v. Cadle Co.*, 51 F.3d 562, 567 (5th Cir. 1995), the Fifth Circuit declined to invent a federal common law right of contribution among parties which violated the automatic stay in bankruptcy cases, reasoning that "bankruptcy is not an area where the courts have wide discretion to fashion new causes of action." In accord *see In re Consolidated Freightways Corp.*, 443 F.3d 1160 (9th Cir. 2006).

With respect to the availability of federal common law, this Court in *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 728 (1979) established a durable test requiring the federal courts to evaluate (1) whether a uniform national rule is required to effectuate the federal program's purpose; (2) whether application of a state law rule would conflict with a policy underlying the federal program; and (3) whether application of a uniform federal rule would

upset existing relationships predicated on state law. Following *Kimbell*, the Court repeatedly has eschewed reliance upon federal common law principles where doing so would upset state corporate law principles. *See, e.g., United States v. Bestfoods*, 524 U.S. 51, 63 (1998) (the Court declines to displace state corporation law using a federal common law of alter ego to fashion a CERCLA remedy against a parent company); *O'Melveny & Meyers v. FDIC*, 512 U.S. 79 (1994) (the Court unanimously rejects a federal common law scheme that displaced traditional matters of state concern, such as corporate governance and whether the knowledge of corporate directors may be imputed to the corporation); and *Atherton v. FDIC*, 519 U.S. 213 (1997) (the Court again held that absent a significant conflict between some federal policy or interest and state law, courts must refrain from fashioning rules of federal common law). Furthermore, this Court has already signaled that generally a federal common law of bankruptcy should not provide the rules of decision in bankruptcy disputes. *See Butner v. United States*, 440 U.S. 48 (1979).

At present state law governs corporate mergers, alter ego, property ownership, and creditor's rights. A federal common law rule of substantive consolidation would displace state law based rights and expectations on such issues. Federal common law should only supplant state law when there is a need for a uniform rule to protect an interest under some federal program or statute. None is evident here.[9]

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[9] The Petitioner argued below that substantive consolidation is authorized by Section 105(a) of the Bankruptcy Code which states, in pertinent part: "the court may issue any order, process, or judgment

(Continued on following page)

The point of this argument is that the Court should not assume that substantive consolidation actually constitutes a valid "bankruptcy law remedy" as implicated by Petitioner's Questions Presented. To be sure, the Petitioner does not present the substantive consolidation issue directly for review, focusing instead on an illusory circuit conflict premised upon lift-stay orders. However, an alternative ground for denial of the Petition is that it is premised upon the incorrect notion that substantive consolidation is a valid "bankruptcy law remedy." Thus even if the court of appeals had erred with respect to issue preclusion, the error is harmless.

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that is necessary or appropriate to carry out the provisions" of the Code. 11 U.S.C. § 105(a). However, the problem with this argument is that there is no "provision" of the Code to be carried out by substantive consolidation in the Chapter 7 bankruptcy cases below. As explained by the Second Circuit in *In re Dairy Mart Convenience Stores, Inc.*, 351 F.3d 86, 92 (2nd Cir. 2003), "the equitable power conferred on the bankruptcy court by section 105(a) is the power to exercise equity in carrying out the *provisions* of the Bankruptcy Code, rather than to further the purposes of the Code generally, or otherwise to do the right thing. This language suggests that an exercise of section 105 power be tied to another Bankruptcy Code section and not merely to a general bankruptcy concept or objective." Furthermore, Section 105(a) of the Bankruptcy Code is derived from the federal All Writs Act, with respect to which this Court has explained does not authorize federal courts to issue *ad hoc* writs whenever compliance with statutory procedures appears inconvenient or less appropriate. *Pa. Bureau of Corr. v. U.S. Marshall Serv.*, 474 U.S. 34, 43 (1985). *See also* Steve H. Nickles & David G. Epstein, *Another Way of Thinking About Section 105(a) and Other Sources of Supplemental Law Under the Bankruptcy Code*, 3 Chapman Law Review 7-20 (Spring 2000) (observing that aggressive uses of Section 105 to achieve non-statutory remedies, including substantive consolidation, may result in a violation of Constitutional separation of powers principles). In sum, Section 105(a) is not a delegation of quasi-legislative powers to bankruptcy judges.

CONCLUSION

The opinion of the court of appeals is not in conflict with that of any other court of appeals. The Petition fails to meet the criteria established by this Court for granting review by certiorari. The Petition should be denied.

Respectfully submitted,

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